Brussels, 10 March 2014

Common position of the European Long-Term Investors association (ELTI) on the own-initiative European Parliament Report on the long-term financing of the European economy

Long Term Investment has gained "policy" ground over the last year. It should be considered a guiding principle of future EU economic reforms, in view of the renewal of mandates at the main EU institutions. Indeed, one of the Eurozone's main challenges lies in the need to raise massive flows of long-term investment to revive growth, particularly in its southern flank, which has faced continued economic decline.

Against this background, Member of the European Parliament Wolf Klinz has been designated as rapporteur for an own-initiative report on the long-term financing of the economy, adopted in plenary session in Strasbourg on February 26th. The general approach of its recommendations, which focus on the main channels to address the EU economy's long-term financing needs, should be welcomed.

1. The detrimental impact of the new financial regulation

The major financial reforms undertaken since 2008 in response to the crisis have resulted in an unprecedented increase in capital requirements under Basel III. Tougher banking prudential ratios have caused a massive deleveraging and increase of bank own funds. This adaptation was necessary and important to correct some of the mistakes of the past and to strengthen the banking system for the future. At the same time, in combination with the perceived uncertainty of the future development of Europe, it has and will potentially lead to tougher credit conditions in particular for long-term investment.

SMEs are the main source of employment in the EU. They have been the most weakened by the shortage of bank credit. This is especially true in southern European countries where prevailing borrowing rates significantly exceed those in Germany and France. Weakened bank credit supply is especially harmful for SMEs due to difficulties in accessing the capital markets (namely small size of company, limited financing volumes, and expensive rating requirements from investors). Therefore, this promising productive sector in terms of growth is at least in some Member States at risk of breakdown and irreversible decline.

Another negative impact of tightening credit conditions consists in the significant unmet long-term financing needs of the infrastructure sector, in terms of new projects, renewal and adaptation of existing equipment.

Antidotes to overcome the relative disengagement of the banking sector should consist of a smooth transition towards capital markets. In addition, banks should be further strengthened as they will remain an important funding partner for SMEs and infrastructure projects.

2. Considering all available options to fund economic recovery in Europe

There is an urgent need to put the EU on track for future solid growth. It involves considering all options to commit investors to address the real economy's long-term financing needs, especially for long cycle

European Association of Long-Term Investors (ELTI) a.i.s.b.l.
Square de Meeûs, 37 – B-1000 Brussels (Belgium)
decrayencour@eltia.eu

productive sectors (SMEs, infrastructure). Klinz's report goes in the right direction by focusing on three ways: adapting financial regulation, encouraging development of securitisation with "real economy" assets on a sound basis and preserving the involvement of banks, insurers and other investors in the long-term financing market.

a. Accommodating the financial regulation devices

The report proposes to better calibrate or revise prudential rules in order to restore consistency between the maturity of assets and liabilities. It acknowledges that there should be no regulatory impairment of institutional investors with a long-term horizon.

Most recent as well as current regulatory activities are focused almost exclusively on the avoidance of risks instead of aiming for an adequate relationship between the complementary goals of financing the real economy and the appropriate distribution of risks. In addition due to the large number of regulatory initiatives there is a serious inconsistency risk between the initiatives. Forthcoming regulatory measures should be taken as a whole concept / entire process, otherwise this could lead to unintended consequences with a detrimental effect on long-term finance. Banks, insurers and long term institutional investors in general should thus be enabled to play again their traditional role as long-term investors.

Therefore, the CRD IV/CRR framework should be revised/ recalibrated as soon as possible to overcome the current shortcomings. In addition, the Solvency II Directive should be aligned with the revised CRD IV/CRR framework.

Fair value accounting approach, which is dominant today, automatically creates volatility in the balance sheet ("mark to model") or in results ("mark to market"). Klinz's report highlights the short-termism of these two asset valuation methods and their pro-cyclical bias over investment strategies.

b. *Maintaining bank involvement in the long-term segment.*

According to Klinz's report, it will be critical also in the future that Banks continue to provide significant support to the long-term financing of the economy. Indeed, their valuation techniques (analysts, risk monitoring), know-how and expertise remain essential to the pump-priming of new credits, in order to stimulate the real economy's long-term financing, particularly in key areas like SMEs and infrastructure.

The new restrictive prudential framework will eventually result into (or is expected to result into) a permanent reduction of long-term assets from bank balance sheets. Indeed, since long-term assets are expected to absorb a significant amount of banks' regulatory capital, there will be an increasing need to make them attractive for other investors while at the same time freeing-up banks capital for prime new credits for the financing of growth. Thus, it is necessary to develop efficient financial structures for the repurchase of long-term receivables for the benefit of institutional and individual investors. However, in order to avoid the originate-to-distribute problems of the past, banks need to keep a substantial interest in the originated loans and develop a standardised approach with more information transparency.
Activating capital markets for financing economic growth (e.g. like in the US) could contribute to a more stable credit supply. However, a more cautious stance should be initially preferred in order to prevent and potentially avoid the shortcomings of the crisis in the US,

c. Revitalising the European securitization market

Klinz's report encourages the responsible development of a high-quality securitisation framework. It is important to stress that – different from the US market – defaults in the European securitization market have remained low during the financial crisis demonstrating altogether sound practices. Nevertheless, adequate measures to incorporate lessons learned since 2008, i.e. promote standardization and avoid unnecessary complex structures, appear reasonable to restore public confidence in the product and prevent possibly undesirable developments in the future.

Market participants perceive currently pronounced regulatory developments as the main obstacle for a stronger recovery of European securitization markets, as these regulatory developments are hindering investments in this area by banks, insurers and other investors. Therefore regulators should focus on three topics: 1) adequate relationship between the complementary goals of financing the real economy and the appropriate distribution of risks, 2) arbitrage free regulatory treatment of different financing alternatives and 3) a holistic approach among all market participants (e.g. Basel III, Solvency II).

National and European public mechanisms aimed at helping to establish a sound market should be introduced. National and multilateral Public Long-Term Investors could intervene as “anchor investors” or public guarantors, primarily in the real estate, infrastructure and business credit areas (see last year’s EC/EIB initiative). Furthermore, the European Commission could introduce a legislative initiative to help to establish a healthy secondary debt market in key sectors (SMEs, infrastructure, mortgages).

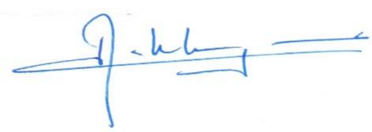
This would require a strong involvement of the banking sector given its loan origination expertise.

d. Mobilising Public Long-Term Investors

The report highlights the key role of Public Long-Term Investors as a catalyst for the private financing of long-term investment, and as the main source of funding for local authorities. Based on this fact, it invites the Commission and Member States to systematically develop and strengthen such institutions in all Member States. This initiative is highly welcomed. At the same time, one has to keep in mind that public long-term investors are usually highly adapted to the specific economic characteristics and necessities of their respective country or region. In further developing this sector, this institutional specificity should be properly respected.

3. Prospects

Improving the capacity of the European financial system to provide long-term support to the real economy could become a major policy priority for the next term (2014-2020). The Single Market Act (1985) methodology, which leaned on a broad range of initiatives with a clear political priority, could be an appropriate model and approach to follow.



Dominique de Crayencour
Secretary General

European Association of Long-Term Investors (ELTI) a.i.s.b.l.
Square de Meeûs, 37 – B-1000 Brussels (Belgium)
decrayencour@eltia.eu