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Ilkka Holmström/Legal Counsel

Green Paper on Long-Term Financing of the European Economy

European Commission
DG Internal Markets
markt-consultation-long-term-financing@ec.europa.eu

The Finnish Pension Alliance/
Työeläkevakuuttajat TELA ry

The European Commission has published on 25 Mar 2013 a Green Paper on Long-Term Financing of the European Economy. In this commentary memorandum, the Finnish Pension Alliance/Työeläkevakuuttajat TELA presents comments first on a general level and in the latter part by answering specific questions brought up in the Green Paper.

The Finnish Pension Alliance represents all Finnish institutional pension companies and institutions engaged in provision of statutory earnings-related pension insurance. Our members hold funded pension assets under management of approximately EUR 155 billion (Q1/2013) and hold diversified asset portfolios. For further information on the allocation and investments, please visit our webpage at www.tela.en/investments.

1 General comments

The concept of financing in general

The Green Paper discusses long-term financing as a separate class of financing. However, this is not always the central focus in practical lending or investment business, because investors and banks also track yield levels of their portfolios and asset allocations as a whole. In this sense, not all investment decisions (or in case of banks, lending decisions) are made as long-term or short-term, but according to individual attributes and risk-yield relation.

Should a bank enter into a loan facility with a loan client, the length of the loan is not likely the only consideration, because consideration is also given to sufficient securities and guarantees, financial condition of the client, cash flow etc. Further, a bank can sell loans or loan books in a matter of few years, even though the maturities would exceed 10 or 20 years. Similarly, an investor might join an infrastructure investment with a length of 20 or 30 years, but dispose it in few years, should the yield-risk relation prove more beneficial for a disposal.

However, these considerations in individual investments or lending operations do not necessarily change the long-term perspective of the investor or bank, when they look at their assets as a whole. This is also why central focus should not be only in how to increase long-term financing, but how to increase financing in EU area with the effect of creating economic growth and employment. It's vital to bear in mind that finance and investing can increase without creation of neither jobs nor growth.

It's also important to note that stricter capital requirements for banking sector reduce the risk taking possibilities of banks. Further, the turbulent economic situation has increased the amount of defaults, bankruptcies and non-performing loans. This combination has reduced significantly

Ilkka Holmström/Legal Counsel

the possibilities of banks to finance SME sector, as the sector is more risky and more vulnerable to economic recessions than many major companies. Many banks are forced to seek only clients with solid finances and sufficient guarantees, because their capital and solvency ratios would otherwise be endangered.

Intermediation in the capital markets

*T*he Green Paper discusses channeling of finance and the effective intermediation of capital markets. However, it would be advisable to focus on creation of right supply for the demand, not of channeling finance in general. Investors and banks require reasonable risk-yield relations for their investments and financing. Capital markets are able to channel equity and capital and create new instruments for demand, but excessive regulation can discourage investing and financing. In EU, it should be considered whether excessive regulation could be partially abolished, especially in sectors where there is a clear risk of overlapping regulation.

Use of fair value in valuation and accounting

The use of fair value can, according to the Green Paper and Staff Working Paper, hamper the long-term investing of some investors, since valuation of assets to fair/market value brings the turbulence of markets to the portfolios of investors. This could impact especially investors with long-term commitments, e.g. pension funds. However, it should be noted that annual shifts in asset valuations will constitute a smaller problem, if the solvency and regulatory rules are enough flexible. The more flexibility there is, the more possiblity there is for long-term ownership of riskier assets during times of economic distress.

Shadow banking

In the Commission Green Paper on Shadow Banking (19 Mar 2012/COM 102), shadow banking is defined in various ways. The Financial Stability Board defines it as "the system of credit intermediation that involves entities and activities outside the regular banking system". The paper also discusses, inter alia, the following entities as possible shadow banks: money market funds, securitization vehicles, insurance and reinsurance undertakings that issue credit products, investment funds including exchange traded funds (ETFs) that provide credit or are leveraged and as activities, securities lending and repurchase transactions.

However, it's important to note that this group is a rather diverse mix of actors with very different functions. The funds described below would not function as uncontrolled or unregulated sources of high leverage, which was one of the dangers of shadow banking actors sited in the paper. Further, it's important to remember that leverage can be controlled or uncontrolled depending on details of each arrangement. This fact was not raised in the Green Paper on Shadow Banking, although it would be critical to bear in mind.

It should be considered whether the establishment of special investment vehicles in the form of debt funds could help the banking sector. The debt investment vehicles would function as opportunistic debt funds currently act, namely purchase troubled loans from banks and removing them from bank balance sheets. Once this would take place in a massive scale, banks would have more possibilities for riskier loans on their balance sheets, e.g. SME loans. Again, non-investment grade loans with senior creditor positions might form a good debt instrument for many debt investors. Also investments into such debt funds could be encouraged by favoring them in solvency rules and by lower capital charges.

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Further, such debt funds could lend directly to SME sector, thereby increasing the amount of financing, and/or provide partly guarantees for SME loans (see below) to enable a higher rate of positive SME loan decisions. Lastly, it’s important to note that as the AIFM directive will enter into force in July 2013, such funds will be under regulation and supervisory control.

Government or EU guarantees for SME loans

Governments or the EU could establish funds or special investment vehicles, which would grant additional securities or guarantees to banks on new SME loans. Should banks receive e.g. 30 – 50 % of the required collateral from the fund, the risk level would be much lower for the bank. The collateral would be a subsidy for banks, and only a nominal fee should be charged from the particular SME entrepreneur.

Subsidies for infrastructure renovation

Instead of focusing on PPP – projects and building of new infrastructure, it would be advisable to consider subsidies for renovation and repair works of existing infrastructure and property. A lot of the infrastructure in Member States is 30 – 100 years old, even dating back to the 19th century. New initiatives regarding energy efficiency will also force a lot of residential and office properties to be renovated during the next 7 – 10 years. Further, renovation and repair works have a significant impact on the employment, and there’s a lot of entrepreneurs that can manage the business. In almost all of the Member States urbanization was intense during 50’s and 60’s, and still at 70’s. This means that there is a potential, huge demand for this industry. Further, a huge share of workforce can participate to the work on the sector, since it does not require such advanced skills as ITC, life science and chemistry.

Concerning insurance and pension institutions

The Green Paper discusses pension and insurance institutions in length, but the central issue of solvency regulation and its effect should be highlighted more. Solvency regulation is a major factor, when investors look at the flexibility of their asset allocation. Moreover, the fact that strict and detailed solvency regulation actually hampers long-term investing, is not discussed. When solvency regulation is flexible and capital charges for specific instruments are not too high, investors are not forced prepare to dispose assets in times of distress, but to focus on a longer term perspective on their portfolios.

Comparison between bank and capital market financing

The Green Paper touches upon the comparison of capital market fund raising and bank lending, as there is a difference between Europe and United States in how these channels are used. In Europe, the role of banks has long been central for corporate sector, whereas in US the role of capital markets and bond issuance is greater. However, the question of the ability of financial markets to efficiently channel funds is not as relevant as the question of what is the level and content of demand and supply. In banking sector many banks have a high demand for stable, investment-grade loan clients with solid finances and strong cash flow. However, such clients are scarce in the SME sector, which is why the critical question is, how to enable banks to take more risk on their balance sheets.

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2 Specific questions raised in the Green Paper

1) Do you agree with the analysis of supply and characteristics of long-term financing?

Both long-term and short-term investments depend mainly on economic outlook and circumstances. Under depression or recession, the risk appetite of companies and banks is reduced. Again, under favorable circumstances there's more room for risk. When analyzing long- or short term investing, the weight of general economic outlook should be borne in mind, and supply and demand.

2) Do you have a view on the most appropriate definition of long-term financing?

Attention should not be given to definitions. The fundamental question is how to promote and increase growth and financing in general, and especially how to improve the situation of banking sector.

3) Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channeling of financing to long-term investments?

The question should be looked at from the perspective of risk-taking and lending capacity. A bank will lend, should a good client with sufficient cash flow and guarantees appear. But in case of a high risk-profile client most banks will not loan during times of economic uncertainty, especially so if banks are already holding non-performing loans in their loan portfolios. Banks have and will have a major role in lending, because the business of lending requires, amongst other things, capable resources and professionals in the lending desks and client work, and in research and analysis.

4) How could the role of national and multinational development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?

It should be considered, whether a development bank could be established, which would focus only on SME loans, or one which would hold a separate loan book focused only for SME loans. This loan book would not be counted in the solvency of the bank, or it could be guaranteed by Member States or from the EU budget. Another option would be a special SME financing fund (SMEFF), which would raise capital with the sole investment strategy of granting SME corporate loans.

5) Are there other public policy tools and frameworks that can support the financing of long-term investment?

It should be considered, whether some parts of new regulation could be abolished, either temporarily or permanently. E.g. temporary easing on bank solvency requirements could help the EU area to better recover in the near future. Once the recovery has picked up, stricter requirements could be gradually returned. Also allowing shadow banking in a greater extent, e.g. through SMEFF entities, could be a good policy tool.

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6) To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

An effective way to engage institutional investors are the solvency rules. Solvency rules and capital charges should be flexible. It's also important to observe that unlike stated in the Green Book on pg. 9, institutional investors are not unaccustomed to illiquid assets and this is not a reason for their smaller share in allocations.

7) How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?

It's important that capital charges would not be too severe for any single asset class, because strict levels of capital charges reduce investor's options for investing.

8) What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?

It would be advisable to consider specific vehicles for SME lending, which would not be restricted by solvency capital rules or charges. This would enable them to loan to SME sector without considering the overall risk level.

9) What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?

As mentioned previously, the most effective way of increasing SME lending would be to help banks take more risk. This can be achieved by a number of ways, which include easing the capital requirements, granting additional guarantee for SME loans and purchasing non-performing or distressed loans from banks into special investment vehicles.

10) Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant they are?

It would be wise to consider abolishing some parts of the financial regulation, as there are cumulative effects and the predictability of new regulatory initiatives is difficult. Another option would be to temporarily ease the capital charges for SII and capital requirements for banks, and then return these regulations in force once the economic recovery has picked up.

11) How could capital market financing of long-term investments be improved in Europe?

It would be advisable to consider, how can capital market financing be improved in general. Merely to look at the capital markets from long-term perspective is not as critical as the functioning of capital markets in general. Again, supply and demand are important. Demand has been high for investment grade issuers, since the economic outlook is uncertain. In some ways the capital markets have improved during the last 12-18 months, since so many major corporations can access bond market with favorable terms and rates.

12) How can capital markets help fill the equity gap in Europe?

Capital markets have already started to function more as a replacement for bank lending, since so many major corporations have been able to tap capital markets with favorable rates. It's also important to remember that many long-term investments are refinanced through their life span. This means that methods specifically designed to increase long-term investments might not succeed, whereas mid-term or short-term operations again might help the general economic situation and thereby improve the conditions for general economic growth.

13) What are the pros and cons of developing a more harmonized framework for covered bonds? What elements could compose this framework?

A harmonized framework is currently not important, especially considering the amount of regulation currently implemented and under planning. Instead of additional regulation, the abolishment of regulation should be considered. In the Nordic countries the financial markets have been stable for the last few years without additional regulation, which is an important issue to bear in mind.

14) How could the securitization market in the EU be revived in order to achieve the right balance between financial stability and to improve maturity transformation by the financial system?

The revival of securitization market has been partly underway during the last 12 months, but improvement of the overall economic situation is important for the market.

15) What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?

EU level savings account would not be an optimal solution, as there are huge differences between the economies of the Member States.

16) What type of CIT (corporate and income tax) reforms could improve investment conditions by removing distortions between debt and equity?

The different treatment of debt and equity stems from the goal of encouraging economic growth. By encouraging the use of debt, many governments have tried to enable faster growth for corporations. Since most nations have adopted this approach, it might actually hamper growth if the treatment of debt would no longer be favored.

17) What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?

It's difficult to say, whether tax incentives can impact the willingness of saving for households, since savings are generally accrued over a longer time period and for many households, saving is part of everyday life regardless of circumstances. There are also wide differences between Member States in EU: in some countries it would be good to have the huge amount of savings in use for investments, but simultaneously there are countries in which households are heavily indebted and it would be vital that households would accrue more savings in such countries. The matter should be left to national consideration.

18) *Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions are granted for specific activities?*

As there are still major differences between national tax systems, it's difficult to plan such tax incentives at EU level. The matter should be left to national consideration.

19) *Would deeper tax coordination in the EU support the financing of long-term investment?*

As mentioned previously, the differences between tax systems of Member States make EU level initiatives difficult. The matter should be left to national consideration.

20) *To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behavior? What alternatives or other ways to compensate for such effects could be suggested?*

Use of fair value should be always linked to taxation; unrealized losses should be tax deductible, if unrealized profits are taxable. It's difficult to say whether fair value leads to short-termism, except in case of too strict solvency regulation. If the solvency requirements and capital charges are high and too strict, investors are forced to dispose assets in case of economic downturn, thereby increasing the cyclicality of real economy.

21) *What kind of incentives could help promote better long-term shareholder engagement?*

The question of long-term or short-term shareholder perspective is generally linked to the industry; many investors look at pharmaceuticals, energy and retail as defensive, long-term industries. Again, other industries are much more susceptible to economic cycles.

22) *How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?*

It's difficult to start planning mandates and incentives at regulatory level. The question is linked to negotiations between the market participants and there's a risk of making asset management too highly regulated business, if new regulatory initiatives would be commenced.

23) *Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?*

As above, the issue should be left outside regulatory scope.

24) *To what extent can increased integration of financial and non-financial information help provide a clearer overview of company's long-term performance, and contribute to better investment decision-making?*

We don't see a critical connection between these factors, especially with regard to institutional investors, as professional investors already have qualified professionals to analyze corporations and investments at professional level. Further, information provided by companies is only one source of information.

25) Is there a need to develop specific long-term benchmarks?

Not currently, considering the number of different benchmarks in use.

26) What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

As there are many risks associated with alternative sources, it would be advisable to concentrate on easing the risk taking capacity of the banking sector.

27) How could securitization instruments for SMEs be designed? What are the best ways to use securitization in order to mobilize financial intermediaries' capital for additional lending to SMEs?

The question should perhaps be, is there a demand for SME securitization market or market place? A careful analysis of demand should first be performed.

28) Would there be a merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitized products specifically designed for SMEs financing needs?

As mentioned above, before considering the merits of such initiatives, the level of demand should be clarified. There are many regulatory initiatives, which have never led to use in the private market, since no actual demand has been in place.

29) Would an EU regulatory framework help or hinder the development of this alternative non-bank sources fo finance for SMEs? What reforms could help support their continued growth?

EU level framework would be most effective, when it would focus on the aforementioned special investment vehicles, which would help bank's risk taking by granting additional collateral or by purchasing riskier loans from the bank's balance sheet. When considering EU –wide regulatory frameworks, it should be noted that the amount of regulation is currently high and cumulative effects have already reduced the effectiveness of the European market and economy.

30) In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of the European economy?

As mentioned earlier, attention should be focused on how to increase financing in general with the effect of creating economic growth and employment, instead of analyzing long-term financing and investing.

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TYÖELÄKEVAKUUTTAJAT TELA RY