FOSTERING MORE INVESTMENT IN THE EU

MARKUS FERBER

MEP, Committee on Economic and Monetary Affairs, European Parliament

Setting the right incentives for private investments

The world as we know it as well as our economies are changing rapidly. To deal with this change, the European Union has given itself an ambitious agenda and identified two major challenges to prepare for: the twin transitions towards a more digitised economy and towards are less carbon-intensive economy.

Particularly the latter one will require massive amounts of investments as it implies a fundamental remodelling of our energy infrastructure from energy generation to energy transmission.

Unfortunately, those investments are not easy to finance. Even before the Covid-19 pandemic struck, we had a consistent and substantial investment gap in the European Union, which the European Union attempted to address with the European Fund for Strategic Investment (EFSI) and later the InvestEU programme.

Even the European Commission has concluded in its "Sustainable Europe Investment Plan" communication that reaching the "old"2030 climate target of a 40% reduction in greenhouse gases would require an additional 260bn EUR in investments. That was arguably before the European Union decided to substantially increase its 2030 level of ambition and before the impact of the Covid-19 crisis.

The pandemic has hit public finances hard and has directed both, public funds and attention away from climate issues and towards immediate crisis relief. The economic fallout of the pandemic will therefore have only increased the investment gap. Part of that delta might be compensated for by the EU's Recovery and Resilience Facility that comes with specific spending targets for digital and climate expenditure.

> If we want to plug the investment gap, we cannot rely on public money alone.

Nonetheless, in light of a higher level of ambition and additional pressure on public finances, the investment gap has probably increased rather than narrowed. That leaves one major conclusion: If we want to plug the investment gap, we cannot rely on public money alone. Even in times of an exceptionally favourable interest rate environment, public finances are stretched. The debt-to-GDP ratio in the Eurozone will likely surpass 100% this year and getting back towards somewhat sustainable debt levels, will leave little fiscal space for grand expenditure programmes.

Ruling out the public sector as a big driver of overall investment, leaves private investment as the key contributor. Private companies will not finance the EU's policy priorities out of the kindness of their heart though, but because they expect a reasonable return. The underlying pre-condition for that is a favourable and predictable regulatory regime, which we have a hand in influencing.

This year, we do have a few chances to get the incentives right: We have three big files that will allow us to set the tracks into the right direction. Firstly, we have the implementation of the Basel III finalisation package, which will determine in a major way how and under what conditions European companies will be able to finance themselves through banks. At a time, when we want European companies to make productive investments, we should be very careful to calibrate the new Basel framework in a way that is conducive to that goal.

Secondly, we have the review of MiFID II, which sets the ground rules of how financial markets in Europe work and how European companies can tap into those markets. We should work on this recast with a view to strengthening EU financial markets, cutting red tape and facilitating market access for both companies and investors. A smart review of MiFID II will go a long way in bolstering up companies' equity base and will allow them to invest in profitable business ventures.

Thirdly, we have the review of Solvency II, which governs how insurance companies can operate across the single market. Insurers are the perfect long-term investors. They have a long-term time horizon and predictable cash-flow needs, yet they currently invest too little in long-term projects, which is due to regulatory reasons. With the Solvency II review, we have a shot at fixing that issue.

If we want to bridge the investment gap, we need to get the legislative framework right to incentivise private investments.

DECLAN
COSTELLO

Deputy Director General, DG for Economic and Financial Affairs, European Commission

Next Generation EU: a pillar of the recovery

More than a year after the outbreak of the Covid-19 pandemic in Europe the economic recovery is yet to gain ground. The breakthrough in vaccine development in the autumn and the start of mass vaccination campaigns are a game-changer that significantly brightens the economic outlook. But in the meantime, renewed waves of the pandemic have forced many Member States to reintroduce or tighten containment measures.

As a consequence, economic activity has remained subdued in the first months of the year. In its winter interim forecast, the European Commission projects only a mild uptick in economic activity before summer. Once the assumed, gradual relaxation of containment measures truly picks up pace in the second half of the year, the economy is expected to start recovering.

Yet, just as the pandemic's initial hit was very uneven across Europe, so will Member States' recovery paths be. More than half of Member States are forecast to close the distance to their pre-crisis output levels by the end of 2021. Others are expected to take longer. The economic structure — and the share of the tourism sector in particular — are among many factors contributing to such an outcome.

The longer the crisis lasts, the greater the risk of major cross-country divergences becoming entrenched, leading to a fragmentation that would disrupt the functioning of the internal market. A protracted crisis also risks inflicting deep scars on the fabric of the European economy and society, predominately through bankruptcies and higher unemployment.

Given the disproportionate impact of the crisis on economically more vulnerable people, including youth and women, a deepening of pre-existing inequalities is also a real risk.

The Member States and the EU have reacted swiftly to the enormous economic impact of the Covid-19 crisis. Swift and determined policy action at all levels has helped to shield firms and workers from losing earnings and jobs in the acute phase of the crisis. The European Commission's €750bn-Recovery Instrument, 'Next Generation EU' (NGEU), complements the various emergency measures by supporting a swift recovery and building a more resilient European economy in the wake of the crisis.

Next Generation EU and the RRF are Europe's attempt to 'build back better', combining future-facing investments with essential reforms.

Its centrepiece, the Recovery and Resilience Facility (RRF), will deliver financial support for investments and reforms in a fair manner. The allocation of financial support takes account of economic needs arising from the crisis while supporting the green and digital transitions of the European economy.

If implemented swiftly, with a strong focus on high-quality public investment and additionality, the level of real GDP in the EU could be roughly 1.5 to 2 per cent higher than without NGEU, according to stylised simulations with DG ECFIN's QUEST model.[1,2] This would help not only the sustainability of our economic model, but also that of public debt.

The common and coordinated European approach to tackling the pandemic's economic consequences is an expression of European solidarity, but it also makes good economic sense. Economic and financial spillovers spread fast through the Single Market and Monetary Union, supporting growth in all Member States. Moreover, high-quality investment and reforms address the challenges ahead – combatting climate change and supporting digitalisation. Our efforts are now fully geared towards the implementation of the RRF. Member States have been developing – in close cooperation with the Commission – Recovery and Resilience Plans that outline national reform and investment measures.

A lot of work lies ahead. However, there are good grounds to believe that Recovery and Resilience Plans can be finalised in months, allowing disbursements to commence around summer. Next Generation EU and the RRF should be seen as Europe's attempt to 'build back better', an endeavour that will require ambition to combine the investments in the right areas with the adoption of essential reforms.

1. European Commission (DG ECFIN) (2020), European Economic Forecast Autumn 2020, European Economy Institutional Paper 136, p.65-70.
2. QUEST is a structural macro-model in the New-Keynesian tradition with rigorous microeconomic foundations and frictions in goods, labour and financial markets. See Burgert et al. (2020), 'A Global Economy Version of QUEST: Simulation Properties', European Economy Discussion Paper 126.

BORIS VUJČIĆ
Governor,
Croatian National Bank

Thousand financial problems of a healthy society

While the magnitude of the initial shock brought by the COVID-19 pandemic may have run out of scale, European policymakers reacted with speed and decisiveness, in a way that may provide a temptation to congratulate themselves. With lockdown policies struggling to contain the virus and scarce vaccine supplies, the lifeline provided by the unprecedented fiscal, monetary and regulatory stimulus has kept our economies afloat.

Not only employment and incomes remained resilient, but also our financial sector, strengthened by the decade of continuous reforms, provided a lifeline to companies. However, if we look beyond the obvious, we may find the same old problems that warrant caution and vigilance.

The banking sector is indeed operating on a lower leverage, taking fewer risks, maintaining substantial liquidity reserves, and overall becoming much more robust and resilient than it was a decade ago. In contrast to the global financial crisis, when the financial system triggered the initial shock and continued to amplify it, this time round banks stood ready to cushion the blow and stabilize the economy.

Still, their first buffer for shocks, profitability, was subdued even before the crisis. This was slowly chipping away at the ability of banks to provide funding to the economy and act as a transmission mechanism for monetary policy.

The reasons for low bank profitability are multiple. European regulators have not always been vigorous to push inefficient banks with broken business models out of the market. Such decisions are not always easy – as we in the Croatian National Bank know very well. Over the past two and a half decades, since I got my first job at the Bank, the number of commercial banks operating in Croatia has shrunk by about two-thirds, coming from 60 down to 20. This has always been a sensitive job, full of legal and political landmines, but the alternative of overbanking is, as we can attest, even worse.

> As our societies overcome the disease, we will again have to deal with our thousand regular issues in the financial sector.

Further on, banks have been slow to reinvent themselves in the face of advances in information and in particular mobile technologies. After several decades of warnings that repeatedly turned out to be false alarms, the speed of technology diffusion in finance has been accelerating. In essence, banks need to become technology hubs in order to maintain their most cherished lines of business. Technological transformation may be painful for banks, and for bankers in particular, but it is the only way forward.

Finally, the long period of extremely accommodative monetary policy has driven interest margins down and compressed income from banks' core business. According to most market observers, this headwind is not likely to disappear any time soon.

On top of reinventing their operations, dealing with the aftermath of the crisis will be particularly challenging for banks. A sharp increase in corporate insolvencies has so far been avoided – to the contrary, exactly the opposite has happened as insolvency rates have fallen below even the levels observed in good years. However, insolvencies will gradually catch-up as broad-based support measures are gradually unwound, even if potentially destructive cliff-effects of a too-early withdrawal are avoided.

Banks will have to make complex decisions to restructure debts of viable companies and pull the plugs on non-viable businesses. The role of a neural vortex entails cleaning the economy of "zombie" firms, which have survived due to ample support, but lack the flexibility to adapt to changing circumstances. This should not be taken lightly.

An old Indian saying that a healthy person has a thousand wishes, a sick person only one, can be adeptly applied to policymaking. As our societies overcome the disease, we will again have to deal with our thousand regular issues in the financial sector, many of them exacerbated by the crisis. Our banks are even more intertwined with national governments than before the crisis, dynamism in the corporate sector has further dropped and banks may again have to deal with a pile of bad debts.

And the banking union still stands uncompleted. So, as we cheer the departure of the disease, we'll be moving to many old unresolved issues again.

MĀRTIŅŠ KAZĀKS
Governor,
Bank of Latvia

We have brought water to the horse, but we cannot make the horse drink

Since the global financial crisis and, in particular, during the Covid-19 pandemic major central banks have provided ample monetary policy accommodation. By several measures, the ECB has provided more support than the Fed. Since 2017 the balance sheet of the ECB in percent of GDP has substantially outgrown that of the Fed. The Fed never resorted to negative rates.

Euro area nominal and real interest rates are near their historical lows. Targeted long-term refinancing operations provide very favorable financing conditions to banks that pass this funding to their lending portfolio. Tiering shields bank profitability by reducing the cost of holding excess reserves when banks cannot pass this cost to their clients.

Unless policy rates go beyond their reversal rate levels, which they have not, zero or negative interest rates are supportive to investment. Ultra-low interest rates should encourage investment as they expand the universe of profitable projects, turning some of those that had negative net present value into profitable endeavors. Of course, some of the recent investment weakness is cyclical, but it is not the whole story. Structural factors must play a role there, too. Let me point to three such factors.

First, the EU common market is still in many ways fragmented, particularly in services. Take the digital domain. Different national requirements still act as virtual borders. Building scale quickly to harness network effects is crucial and the national markets of even the largest EU countries are too small for that. It is somewhat ironic that cross border retail transactions in the EU are mostly enabled by payment solutions developed outside the EU. We need to complete the single digital market and create a retail payment solution based in the EU. The latter should ideally be a private sector solution. A digital euro could support it.

Second, financial markets in the EU are dominated by banks. Underdeveloped capital markets, especially in smaller jurisdictions, mean fewer sources of financing for investment and innovation, less diverse risk taking and a limited set of business strategies, especially if the market is dominated by just a few big lenders. Moreover, the profitability of the European banks has been weak and that is only partly a cyclical issue.

In addition to monetary policy, we need two more games in town - structural reforms and bolder fiscal policy.

Despite the efforts to strengthen the European banking union, banks largely remain domestically oriented, with a strong bank-sovereign nexus. As a result, they are not able to reap the full benefits of European integration. Extra efforts are needed to move towards a genuine European banking union. At the same time, banks cannot and should not intermediate all risks.

A more diverse financial market ecosystem is a must. Deep and well-functioning capital markets are not a luxury. Without a dynamic capital market, Europe risks more under-investment, a less vibrant economy and lost opportunities for its citizens.

Third, frontloaded and investment-geared fiscal support is needed both at the national and the EU level. The euro area non-financial investment has not yet fully recovered from the austerity of 2012-15. In view of worsening corporate balance sheets, low cost of sovereign financing makes it possible for the public sector to fill in the most critical private sector investment shortfalls.

True, national fiscal policies have been expansionary during the Covid-19 crisis, but little of it has supported investment. While the USD 1.9 trillion Biden package could risk being too concentrated in time and overheat segments of the US economy, it is projected to close the output gap already at the turn of the year.

The EUR 672.5 billion EU Resilience and Recovery Fund is a very welcome step in the right direction but is stretched over five years, only to visibly kick in towards the end of the year and will not close the negative output gap neither this year nor next. With single monetary policy, a larger common fiscal capacity would yield a more effective policy mix. If we let long-term investment dwindle, productivity and income growth will be anemic.

To summarize, in addition to monetary policy, we need two more games in town - structural reforms and bolder fiscal policy. Paraphrasing an old saying, central banks can make sure that there is plenty of water in the river, we can even bring water to the horse, but we cannot make the horse drink.

PIERRE HEILBRONN

Vice President, Policy & Partnerships, European Bank for Reconstruction and Development (EBRD)

Recovering sustainably from the Covid-19 crisis – focus on CEE

The word "sustainability" is in vogue now – it is used so often and in many different contexts that its original meaning can sometimes get lost. But when it comes to recovering sustainably from the economic crisis precipitated by the Covid-19 pandemic, we need to go back to first principles. It is important that we tackle this recovery in a manner that will endure beyond emergency interventions, so that we give true meaning to our promise to "Build Back Better."

Understandably, the emergency response of governments worldwide, including in the Central and European (CEE) region, has been focused on individual's incomes and corporate liquidity. Because of the severity of the crisis, there is always the risk that well-intentioned kneejerk reactions could lead to less sustainable outcomes. For example, increase in state ownership of companies to protect corporate balance sheets is likely viewed as systemically important. As a multilateral development bank with a distinct private sector mandate, the EBRD recognises that these types of solutions are likely during crisis, but we will be there to advise when such emergency measures need to be reversed to promote a private sector-led recovery that is both inclusive and sustainable.

When we interpret "sustainability" in its broader sense, meaning the ability to continue over a prolonged period of time, we need to look at the diverse tools at our disposal. At the EBRD, we are committing all of our activity in 2020-2021, worth €21 billion, to help our regions counter the economic impact of the pandemic.[1] Separately, all eleven CEE EU members will be net recipients of grants and will have access to new, cheap loans under the EU's EUR750 billion pandemic recovery plan. It is encouraging that the Rating Agency, Fitch, forecasts higher growth for all bar one of these countries in 2022 than 2021, making the CEE region stand out.[2]

However, no single source of finance will come to the rescue – they need to be manifold and diverse. That is why the EBRD has focused on introducing new products in the region, such as the Commercial Paper (CP) programs to mobilise emergency assistance for working capital as well as Banking sector capital Instruments to strengthen the capital base and promote new lending.

> We must tackle this recovery in a manner that endures beyond emergency interventions, so that we give true meaning to our promise to Build Back Better.

Interpreting "sustainability" in the more narrow sense, in terms of its impact on environmental matters, the EBRD recognises how important it is that there is a post-Covid green recovery. The emergency response in the CEE has so far not focused on green stimulus measures. However, if they are properly targeted, public policy interventions could spur economic growth in a more climate-friendly way. Policymakers should harness this unprecedented opportunity and use it as a springboard to a greener path. And a new vibrant group of investors is supportive of ESG goals and they are not shy in directing money to a sustainable future. Positives are already occurring in Poland and the Czech Republic, with both countries attempting to move to a future less dependent on coal.[3]

Separately, in Hungary, the Central Bank is working with the EBRD to develop a sustainable capital markets development strategy, which will complement its ongoing initiatives aiming to green the financial system and to mitigate the risks of climate change. A similar project is ongoing in Lithuania.

The genesis of many of these initiatives pre-date the Covid crisis, but are even more relevant now. And there are other reasons to be optimistic for the CEE region: the International Renewable Energy Agency has confirmed that there is huge potential for clean energy there. According to a recent study, the economies of Central and South-Eastern Europe could cover 34 per cent (from 16% in 2015) of their rising energy demand cost-effectively with renewables by 2030.[4]

At the EBRD, we stand ready to support them in their transition.

1. https://www.ebrd.com/what-we-do/coronavirus
2. https://www.fitchratings.com/research/sovereigns/next-generation-eu-fund-to-boost-cee-sovereigns-growth-in-2022-13-01-2021
3. https://think.ing.com/uploads/reports/CEE_Green_Opportunity_Master_3_Nov_-_FINAL_.pdf
4. https://www.irena.org/-/media/Files/IRENA/Agency/Publication/2020/Oct/IRENA_REmap_CESEC_2020.pdf

LAURENT ZYLBERBERG

Director of Public, International and European Affairs, Caisse des Dépôts (CDC)

Public finance is not the problem, it's part of the solution!

In this unprecedented crisis that our economies have gone through and from which we continue to suffer the consequences, one must think without blinders. We all see the new legitimacy of public intervention. We, NPBIs, have spared no efforts to contribute to the deployment of various and massive emergency measures. This is not enough! Our role is also to prepare the future by restoring today's economies and preparing tomorrow.

Figures speak by themselves, in France alone, in 2020, CDC via its subsidiary Bpifrance has supported 630,000 companies for an amount of loans guaranteed by the French State of €130 billion. Among many other initiatives, we also set up regional funds with local authorities (more than €300 million) for small businesses and social economy.

At European level, figures make dizzy (€ 750 billion of immediate measures in 2020 in 5 Member states). European NPBIs gathered in ELTI[1], were mobilized on all fronts (loans, equity, guarantee) to support their domestic economies and mitigate the severe effects of the pandemic.

Responding to the emergency by providing cash and short-term debt is only part of our job. Financing the recovery by providing long-term financing is another part. Following a sharp increase in indebtedness, strengthening companies' equity is another challenge. For that one, we, NPBIs, must take risks and leverage on other financial resources. This is why the success of European Program like InvestEU is so important with the direct access to European guarantee granted to NPBIs.

In a context of strong uncertainties and low interest rates (which pay poorly for risk taking and long-term commitment), it is quite difficult to find long, patient capital in capacity to bear risk. However, there is a paradox on which we could count on. Because of the current crisis betting on long term is probably less risky than on short term! Having said that, we shall not shoot ourselves in the foot.

All the actors should work for establishing a positive and incentive regulatory framework. Financial robustness and stability shall not be regarded as incompatible with risk taking in the long term. Of course, this is lacework, especially for prudential and accounting concerns, but it is worth to do it rather than having a holistic vision which could have so much collateral damages.

Together we shall do more!

In this context, because of our positive track-record, our knowledge of local needs and the constant support we received from public authorities, we, NPBIs, have a major role. We accompany our partners for taking risks and committing to long horizons, we help them into taking account of externalities in their investment decisions. Based on that, we can be considered as "enablers".

But for them to give their full potential, the NPBIs must benefit from support not only from their national governments (within the framework of domestic recovery plans) but also from European institutions as "implementing partners" of the EU financial instruments. In this respect, InvestEU as a cornerstone of the EU recovery plan illustrates this new decentralized approach of investment policies.

Besides, the regulatory environment applicable to long-term investment should not be discouraging so that long-term financial players can accomplish their role as a "catalyst": from this point of view, vigilance is required, for example, on the possible reinforcement of capital requirements on banking investment in equity with the Basel IV transposition.

As said above, recovery is only one part of the job. The most substantial part of it is to ensure resilient growth, sustainable development and digital transition and therefore adapt our economies. For this, we ought to build a diverse ecosystem of financial institutions with NPBIs playing a key part and appropriate incentives in terms of long-term sustainable finance. Taxonomy, reporting, incentive measures and many other elements shall be defined towards this goal.

Finance of all sorts, unite! Together we shall do more!

1. European Long Term Investors Association

SYLVAIN BROYER
Chief Economist EMEA,
Fixed Income Analytics,
S&P Global Ratings Europe Ltd.

The role of the Capital Markets Union in avoiding the liquidity trap

The liquidity trap occurs when consumers and businesses show an absolute preference for holding cash rather than investing because returns are too low. This leads to the central bank no longer being able to influence financing conditions. How can Europe avoid the liquidity trap?

European households and corporates have hoarded a large share of the liquidity that governments and central banks have injected into the economy to combat Covid-19 pandemic. However, that does not mean Europe has already fallen into the liquidity trap. After all, Europeans have had little opportunity to spend amid strict lockdowns. When restrictions to demand were lifted temporarily in summer 2020, households considerably scaled back their savings.

Moreover, productive investment has not decline further than GDP last year. In fact, it has increased continuously faster than GDP since the ECB introduced negative interest rates and QE in 2014. So, monetary policy does not seem to have lost all traction, and we will have to wait until well after the health situation normalizes to see whether Covid -19 has pushed Europe into the liquidity trap.

In the context of the EU's Capital Markets Union project, it is nevertheless unfortunate that the massive liquidity injected during the pandemic has not found a more effective use. Europe already had a huge pool of savings before Covid. The share of cash to financial assets held by companies has increased by two percentage points to an all-time high of 12.4% over the past three quarters.

More than two-thirds of households' financial transactions last year landed in bank accounts, while less than 2% were used to increase direct equity holdings. Cash and deposits replaced equities as the main class of financial assets held by European households in 2008.

Since then, the return on bank deposits has fallen to zero, while dividends on European equities offered a constant 3% per year. The unproductive use of EU savings is not only unfortunate for savers. It is also regrettable for SMEs in Europe which, as the IMF recently pointed out, suffer from a substantial equity gap of about 2%-3% of GDP (See IMF WP/21/56). This gap has widened due to Covid -19.

The Capital Markets Union, spurring investment and return on savings, is vital to the economic recovery.

There are two ways to escape a liquidity trap, as Buiter and Panigirtzoglou described (See NBER WP 7245). The first is fiscal expansion. The second is for the central bank to lower the effective zero low bound on interest rates. Covid -19 has helped reduce the liquidity trap risk somewhat by triggering a bold policy response, both monetary and fiscal. The EU Green Deal would probably not have been endowed with €750 billion funding without the pandemic. EU budget rules would not have been relaxed.

The ECB would probably not have pushed long-term yields further into negative territory and further loosened refinancing conditions for banks. The latter might positively influence banks' ability to charge negative interest rates on customer deposits, but the process remains slow and uneven, and still tilted more towards corporate deposits than households' deposits (See Bundesbank Monthly Report February 2021 Box pp34-35).

While acting further on these two levers might alleviate the risk of falling into a liquidity trap, they would not make the allocation of savings in Europe more effective. This can only be achieved by completing the Capital Markets Union and, above all, by incentivizing retail investors to increase their direct or indirect holding in equities. Beyond the planned reviews of the regulatory framework for institutional investors (Solvency II, AIFMD, ELTIF, MiFID II/R, CRR2), access to independent financial advisers and improvements in savers' financial literacy are essential.

Positive tax incentives for retail investors would also help shift savings from bank deposits toward direct or indirect equity holdings if banks remain hesitant to pass negative interest rates to retail depositors. In a post-Covid world, the poor alternative to completing Capital Markets Union would be for EU states to fill the SME equity gap. This would necessitate direct participation financed by taxes. Europe can do better.

Capital Markets Union is vital to the economic recovery. It can help avoid the liquidity trap and spur investment by providing a better return on savings.

CYRIL ROUX
Deputy Chief Executive Officer, Groupama

Lighter capital requirements would allow European insurers to provide capital to the economy

European insurance regulation is not primarily designed to nurture the role these institutional investors can play in financing the European economy. The primary objective of regulation weighing on European insurers is to protect policyholders, from a twin prudential and consumer perspective. The detrimental effect of this regulation on investment capacity is recognized, but as a side-effect.

Furthermore, whenever a thought is given to the macroeconomic import of the insurance sector as a whole by EU institutions, it isn't primarily to address its investment capacity, thereby counterbalancing the aforementioned detrimental effects of microprudential regulation, but once again rather to address the risk the sector as a whole might pose to the economy by adding a further layer of so-called systemic regulation, thereby aggravating the investment disincentives already built in Solvency 2.

There wasn't anything foreordained in the unfavorable treatment of equity investments in microprudential regulation. When taking into account the time horizon of insurers as going concerns, the schedule of their cash flows and the structure of their liabilities, it is clear that a balanced portfolio comprising a sizable portion of well diversified equity investments is a better match than the current mix of their assets, which is massively overweight in fixed income. However, once the decision has been made instead to devise capital requirements on the basis of a mistaken one-year horizon, there is no escaping the fact that equity values can drop a lot in an accounting year, and thus to require a larger amount of capital for investing in equity rather than in debt instruments, notwithstanding their higher correlation and their lower rate of return.

It is unfortunately likely that the revision of Solvency 2 will go even further in turning insurers away from equity instruments. The sharpness of the drop of the interest curve in the recent years well below zero percent and the manifest flaws in the design of the standard formula has brought EIOPA to promote a large increase in the capital charge for fixed income instruments. A cursory view would welcome a reduction in the gap between regulatory capital requirements for equity and debt instruments; it would seem to reduce the disincentive to invest in equity.

> A set of capital charges reducing the overall solvency ratios of the insurance sector will bring insurers to reduce their investment in equities.

A plurality of governments sought for this reason to reduce the regulatory gap between instruments in the revision of the delegated Act by lowering the capital charge for some equities. However, this approach is mistaken and will not bring about the desired outcome. What counts, first and foremost, is the absolute level of solvency ratios. A set of capital charges reducing the overall solvency ratios of the insurance sector will bring insurers to reduce their investment in equities, even if the specific capital requirement in equity is lowered and the capital requirement for fixed income instruments is increased.

The French government has given much thought to the investment role of insurers for years and seeks to address it in part by creating a sizable pot of hybrid instruments. French insurers would invest in diversified funds of hybrid loans extended to French SMEs; these funds would benefit from a first loss guarantee from the French government, so as to apportion the risk between the issuer, the underwriter, the investor and the taxpayer. Depending on the quality of the underlying credits, the interest rate charged, the attachment point of the public guarantee and the diversification of the funds, these funds might help the national economy while providing a satisfactory risk-return profile to their institutional investors or to the life policyholders as ultimate beneficiaries.

However, the regulatory treatment is yet to be known, and the misalignment of interest between originators, which may own other exposures in the capital structure, and investors makes the structure a complex proposition. Although large in absolute terms, the overall pot of hybrid loans would be around 1 percent of life insurance policyholders funds. Hence, reducing overall capital solvency requirements remains key for unlocking the investment capacity of the European insurance sector.