Associazione Nazionale
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The role of the Insurance industry in financing the real economy

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Financing the real economy

Financing the real economy (1/2)

The credit crunch

In Europe SMEs account for 65% of the workforce; in Italy the percentage is no less than 80%

They are heavily dependent on bank credit.

- Evidence shows that:
  - **the recent recession resulted in a significant credit crunch**, which was more severe for the banks in the countries under greater stress.
  - SMEs may have more difficulty than larger firms: structural constraints hamper viable SMEs' ability to invest, thereby undermining economic recovery.

Financing the real economy (2/2)

The need for new sources of long-term financing

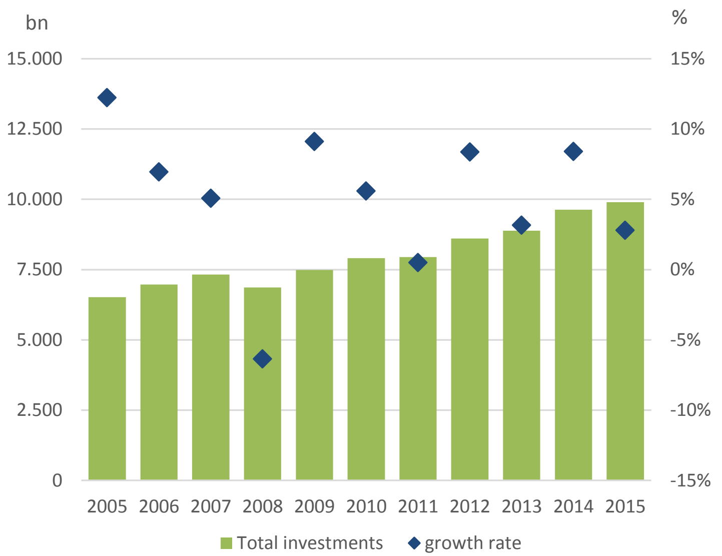
- All modern banking theories stress the privileged role of banks in financing SMEs
- Current unsatisfactory growth performance points to the need for long-term investments that can foster economic recovery
- With banks still concentrating on the need to raise additional capital and penalized by impaired assets, **it is fundamental to extend the range of sources of long-term funding for SMEs**

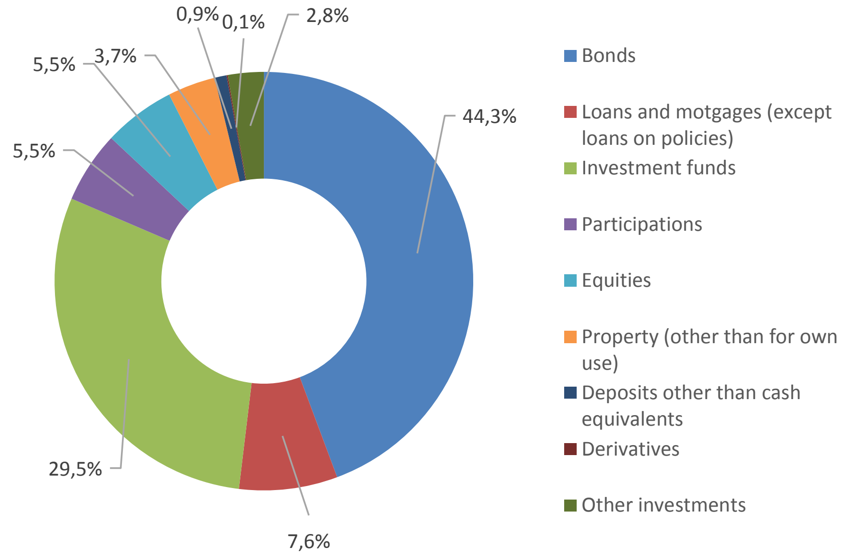
Insurance companies can play an important role in this framework

Insurance companies’ investments

Insurance companies' investments (1/5)

Insurance companies are the largest institutional investors in the European economy, with €10 trillion worth of assets under management





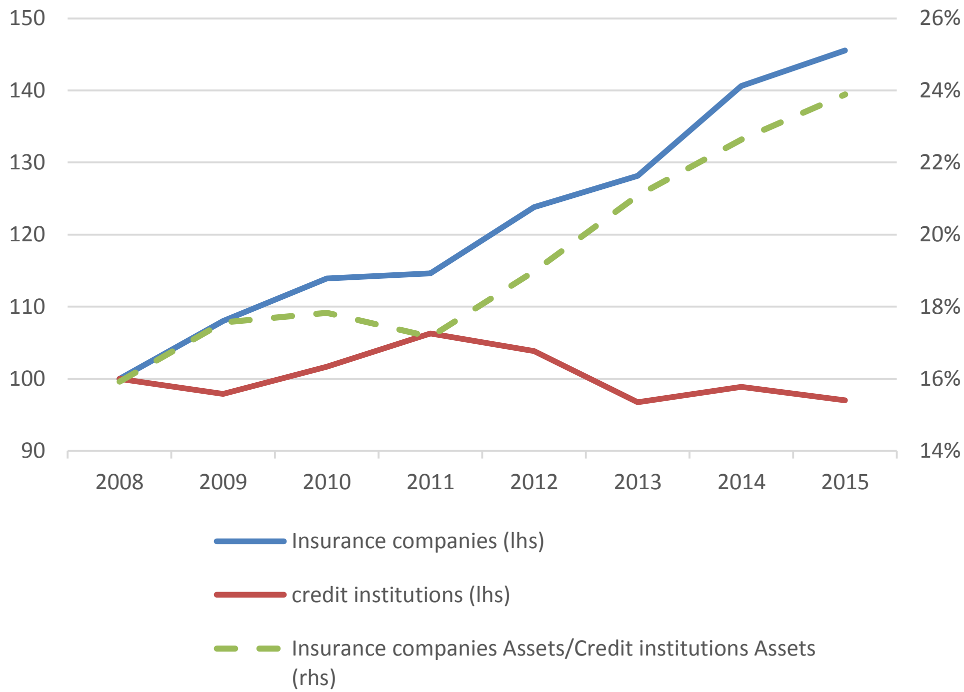
Source: ANIA calculations on Insurance Europe data; 2014 figures

- ✓ ***equivalent to around 60% of the Union's GDP***
- ✓ ***over half of all institutional investments in Europe***

Insurance companies' investments (2/5)

Insurance vs. banking industry

Growth of total assets of insurers compared with banks in the euro area



- Over the past ten years, **the volume of insurers investments has grown by around 50%,** notwithstanding the financial crisis.
- Since the crisis **insurers' assets have grown steadily**, filling some of the vacuum left by deleveraging banks (ESRB, 2015).

Source: European Central Bank, Statistical Data Warehouse; 2008 indexed at 100

Insurance companies' investments (3/5)

The potential role of the Insurance sector in financing real economy

The insurance industry, especially in Europe, has a very significant investment potential, which needs to be matched with suitable long-term assets

- The interest of insurers for long-term investments in the real economy stems from their need for:
  - greater diversification of asset allocation
  - higher returns in the persistent low-interest-rate environment
  - and a better match of assets with long-term liabilities.
- The European insurance industry is accordingly interested in investment in asset classes that can have an immediate impact on growth, such as infrastructure (debt, equity), securitisations and credit.

Insurance companies' investments (4/5)

Investments in Solvency II

- As of January 2016, European insurance companies have been operating the new **Solvency II** regulatory framework, which **has drastically altered the mix of restrictions and incentives governing investment decisions**

New rules:

- still give privilege treatment to government securities, even though differently from the past;
- discourage investment in shares;
- penalize long-term and low-rated bonds, perhaps excessively in relation to effective risk;
- disproportionately favour direct investment over securitisation

Insurance companies' investments (5/5)

The case of Italy

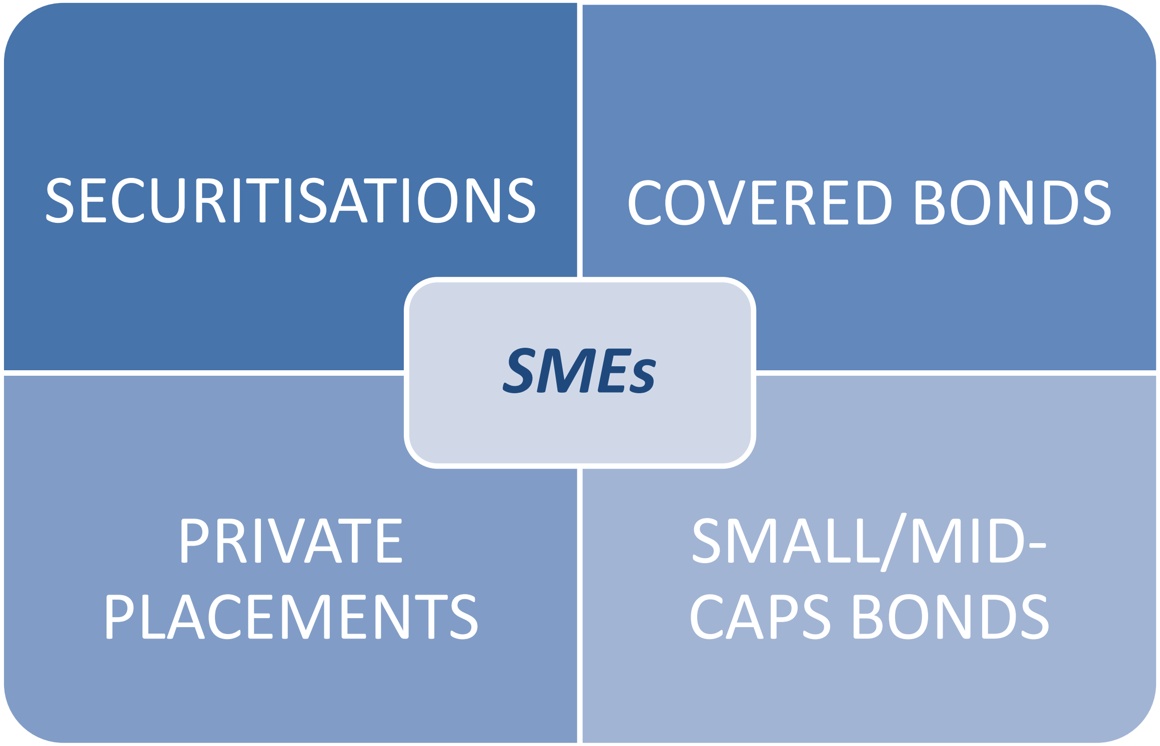
- In Italy Government bonds have always represented the principal investment asset for Italian insurers
  - between 2008 and 2013 their weight increased substantially.
- Subsequently, however, their share has fallen (from 57% in 2013 to 54.1 % in 2015), owing to:
  - falling yields (and a narrowing of the spread vis-à-vis better rated securities) and
  - the impending application of Solvency II.
- Corporate bonds share of the portfolio rose from 21.0 to 23.5 percent in the same period.

The role of insurance companies in financing SMEs

The role of insurance companies in financing SMEs (1/7)

Insurers' instrument of choice for the financing of SMEs

- There are essentially four market-based debt instruments for SME financing:



The role of insurance companies in financing SMEs (2/7)

a) Securitisations

- According to IMF the outstanding stock of transactions in the European term securitization market in 2014 was €1.5 trillion;
  - the market was dominated by bank-sponsored RMBS (about €875 billion),
  - loan-backed SME securities (SME securitization) constituted less than a tenth, at €121 billion.
- In practice, then, <u>there is no SME securitization market</u>.

Long-term investors like insurance companies and pension funds have the size and the resources for significant investment in SME securitization

However, <u>they face regulatory problems and information asymmetry</u>.

The role of insurance companies in financing SMEs (3/7)

Securitisations

- According to a recent Communication by the European Commission, the primary objective, to be achieved rapidly, is to "build EU securitisation markets" (Action 22 CMU Action plan)
- EC Proposal for simple, transparent and standardized securitizations (STS) contains a number of additional positive elements; however, the current <u>Solvency II calibrations still need to be reduced further in order to reflect the true risks</u>:

  - the STS criteria proposed in the securitization regulation have to be quickly aligned with the "Type 1" standards of Solvency II.
  - capital charges for STS securitizations (currently "Type 1") should be aligned with those for corporate bonds.
  - all tranches of STS securitizations should receive a more risk-sensitive treatment, avoiding the current "cliff effect" between the senior and junior tranches within the same STS.

The role of insurance companies in financing SMEs (4/7)

b) Covered bonds

- European covered bonds form one of the continent's largest private debt markets.
- From the investor's perspective, covered bonds offer diversification, low risk and good quality investment, in that they are typically rated higher than the unsecured senior debt of the same issuer.
- <u>However, the market is highly fragmented</u>
  - Loans to SMEs are eligible in only a few countries, and in any case the SME segment is relatively new and small.
  - Investors too are generally marked by considerable home-country bias.
- Moreover, in the CMU consultation, public authorities favoured the exclusion of ship, aircraft and SME loans from the cover pools of "regulated covered bonds".

It is hard to see how this kind of instrument could become a privileged channel for SME financing.

The role of insurance companies in financing SMEs (5/7)

c) Private placements

- The volume of funds raised by European issuers in the private placement market was €45 billion in 2015, up 50 percent from 2014 (S&Ps, 2016):
  - about €12 billion was placed in the US private placement market,
  - €19 billion in the Schuldschein market, made up mainly of German and Austrian issuers,
  - €14 billion in the Euro Private Placement Market (EPP).

International insurance companies are among the largest investors in all three segments of the European private placement market.

The role of insurance companies in financing SMEs (6/7)

c) Private placements

- In quantitative terms private placement represents insurers' instrument of choice for the direct financing of SMEs.
- In any case, careful consideration must be accorded to the fact that by their very nature private markets are less transparent than regulated markets and that the SMEs interested in finance other than bank loans are often the riskiest.
- It is necessary to give investors the greatest possible security in terms of due diligence, price discovery, and deal execution

Two conditions must than be satisfied:

- greater contract harmonization and standardization
- a regulatory treatment which, if linked to the real risk of the transaction, could also constitute a formidable tool for information sharing and the development of the market.

The role of insurance companies in financing SMEs (7/7)

d) Bond exchange platforms (mini-bonds)

- Bond issuance via exchange platforms for SMEs seeking funding of less than €200 million has remained modest, around €3 billion a year (S&P, 2016).
- A particularly significant experience has been the growth of the minibond market in Italy, thanks to the removal of the main legal and fiscal obstacles that had prevented SMEs, de facto, from issuing bonds.
- In addition,
  - measures were taken to make it less costly to obtain the requisite accessory guarantees, facilitating the issue of secured bonds.
  - the setting up of specialized funds or securitization vehicle companies has also been favoured, in order to sustain the aggregation and professional selection of minibond portfolios to present to the capital market.
- In November 2016 the total volume of securities issued was €8.7 billion (for 150 issues), at yields of around 5% and maturity of about five years.

The role of the public sector

The role of the public sector (1/2)

Promotional banks and EC initiatives

- Many advanced countries have adopted a model of support to small enterprises based on “promotional banks”
- A number of initiatives have been undertaken in recent years to encourage long-term investment in the real economy.
  - Investment Plan for Europe” (the Juncker Plan) was approved in June 2015
  - the European Fund for Strategic Investments (EFSI) was launched immediately thereafter

It is essential to be aware that the success of such initiatives must be judged exclusively by their ability to involve private capital in the financing of “additional projects.”

The role of the public sector (2/2)

Taxation of savings

- The Commission is taking action to increase equity financing (EC, 2016) by addressing the preferential tax treatment of debt over equity, which should encourage more equity investments and create a stronger equity base in companies (Action 12, CMU Action Plan).
  - this action is moving in the right direction, though its effective innovative scope needs to be evaluated.
- However, how to provide the right incentives for savers to seek out long-term investments?

A number of countries have schemes to foster the channeling of household savings into productive investment on a stable basis.

<u>In 2016 Italy introduced its long-term saving plan provision, modeled on the French Plan d'épargne</u>

Conclusions

Conclusions (1/2)

Financial regulation, and prudential insurance regulation in particular, crucially affects insurers' investment behavior…

…and therefore their contribution to financial stability and economic growth, which for many reasons will be increasing in the near future.

The public sector, through promotional banks, has a fundamental role to play as anchor investor or guarantor of worthy private-sector initiatives.

The actual amount of resources that will flow to the real economy through new schemes such as taxation of savings remains to be seen. In any event, it would certainly be useful to encourage the spread of best practices.

Conclusions

What capacity insurance undertakings have to sustain the financing of small and medium-sized enterprises?

- A positive response to the question of whether insurance companies can facilitate SMEs' access to the capital market depends crucially on two factors:

prudential regulation must avoid excessive capital charges for certain types of investment

formation within the capital markets of asset classes, other than traditional corporate bonds, expressly designed for the financing of SMEs