

Global Agenda Council on the Future of Insurance and Asset Management

Strengthening the Real Economy Harnessing the Power of Long-Term Investors

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Global Agenda Council on the Future of Insurance and Asset Management

Strengthening the Real Economy **Harnessing the Power** **of Long-Term Investors**

Executive summary

Four challenges facing long-term investors

Long-term investors (LTIs) such as pension funds, insurers, endowment funds and foundations, sovereign wealth funds, and traditional asset managers¹ manage ~ 32% of all financial assets worldwide. They play a key role in the global financial system and the world economy as they are central providers of individual savings and retirement solutions, and channel savers' money to borrowers, supporting productive long-term investments.

As public policy shifts focus from stabilizing the financial system in the wake of the financial crisis to fostering economic growth and tackling societal issues such as rising pension and infrastructure gaps, LTIs could play an increasingly important role. Given their significant financial clout, LTIs feel that they could more effectively support the growing needs of aging societies and the global growth agenda. To understand the opportunities for LTIs, the Global Agenda Council on the Future of Insurance and Asset Management (GAC) conducted more than 50 interviews with senior representatives of governments, regulators, academia, and the LTI community.



The interviews and numerous discussions within the GAC revealed the following four key challenges for LTIs in the financial system and elicited recommendations on how policymakers and LTIs can work together to harness LTIs' full potential for supporting the real economy:

- 1. Repercussions of the crisis** – the balance of public policymaking between ensuring financial stability and facilitating economic growth requires recalibration, and the financial system needs a more cohesive policy framework. These changes would remove distorted risk-return characteristics and reduce the administrative burden that are currently seen to limit LTIs' ability to invest.
- 2. Policy framework for LTIs** – efforts to better account for differences in business models, funding structures, and leverage ratios in regulation need further reinforcement. The current regulatory framework does not reflect these differences sufficiently, which creates an unlevel playing field and constrains long-term investments.
- 3. Market structure** – corporate credit market structures require enhancement, and private infrastructure financing possibilities need improvement. Underdeveloped corporate bond markets, liquidity risk in fixed-income markets, and suboptimal infrastructure financing conditions limit productive long-term investment possibilities.
- 4. Interaction of LTIs and policymakers** – LTIs should increase their coordination and fact-based involvement in regulatory processes, and regulators should solicit more advice from LTIs. This would counteract LTI tendencies towards self-centered and siloed campaigning and would make the dialogue between policymakers and LTIs more effective.

¹ Excluding alternative asset managers such as hedge funds or private equity funds

Introduction

From financial system stability to economic growth

In the wake of the financial crisis, public policy intervention in the financial system increased significantly. Governments, regulators, and central banks mobilized forces on the national and international levels to secure financial stability and decrease leverage and, in particular, to save the banking system. Concentrating all efforts on financial stability was pivotal to containing the crisis successfully.

With the crisis abating, other objectives took center stage, shifting the focus from stability to economic growth. Post-crisis, many economies, especially in Europe, are struggling to rekindle economic growth. Unemployment rates increased during the financial crisis and remain significantly higher in many countries than before the crisis. Furthermore, many countries are struggling with substantial public debt.

The constrained economic recovery forces central banks to maintain historically low rates and unconventional policy measures, such as quantitative easing, which cause financial repression, lowering investment returns and limiting savings opportunities for individuals. This is especially dire as the population in many developed and emerging countries ages, creating additional challenges for pensions and other social systems.

Part of the growth issue is attributable to the sluggish recovery of investment after the crisis (Exhibit 1), which not only reflects the excessive public debt burden but also the lack of long-term financing for corporations and small- and medium-sized enterprises (SMEs), and insufficient investment in public infrastructure. As many governments need to reduce their debt levels and cannot address issues such as the mounting pension and infrastructure gaps alone, they require more, not less, support from the private sector (Exhibit 2).

In this context, the spotlight shines particularly on LTIs such as pension funds, insurers, endowment funds and foundations, sovereign wealth funds, and traditional asset managers, that manage ~ 32% of global financial assets. They play a key role in the global financial system and the world economy (Exhibit 3).

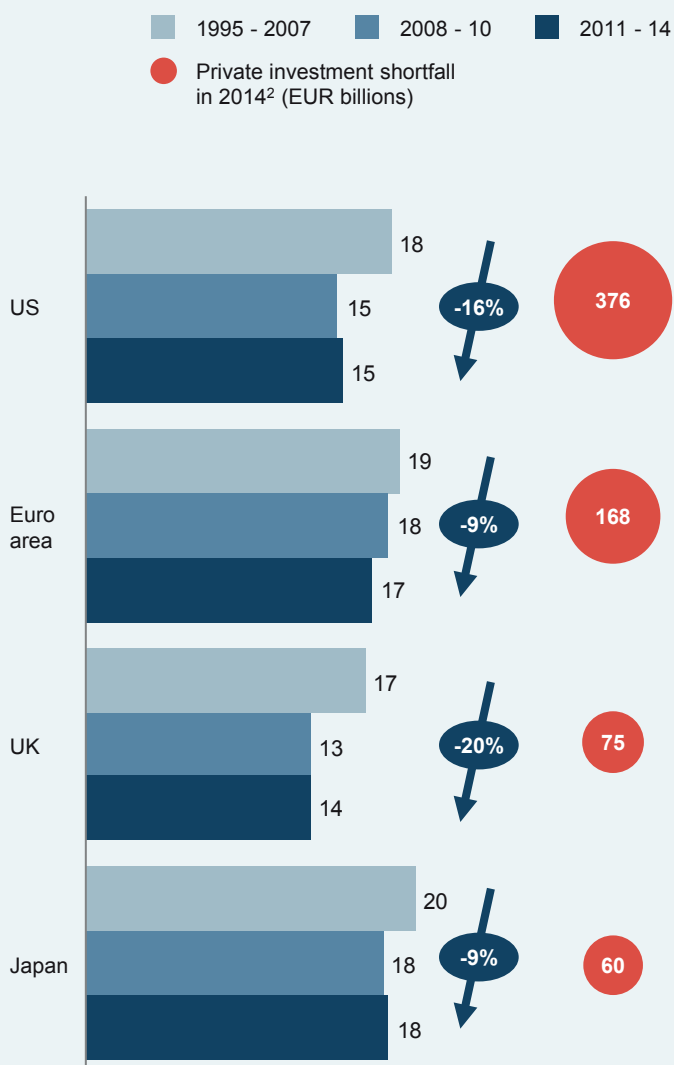
While LTIs have diverse business models, their common characteristics (e.g., typically long-term funding, no “bank-run” risks, and low leverage) allow them to invest for the long term and usually carry less systemic risk than banks or other short-term funded intermediaries. Their long-term investment horizon is very well matched with government interest in sustainable value creation and well suited to addressing at least some of the issues outlined above.

Exhibit 1

Private investment plummeted during the financial crisis and has not recovered

Private¹ investment, 1995 - 2014

Percent of GDP



¹ Includes investment by nonfinancial/financial corporations, households, and nonprofit institutions serving households

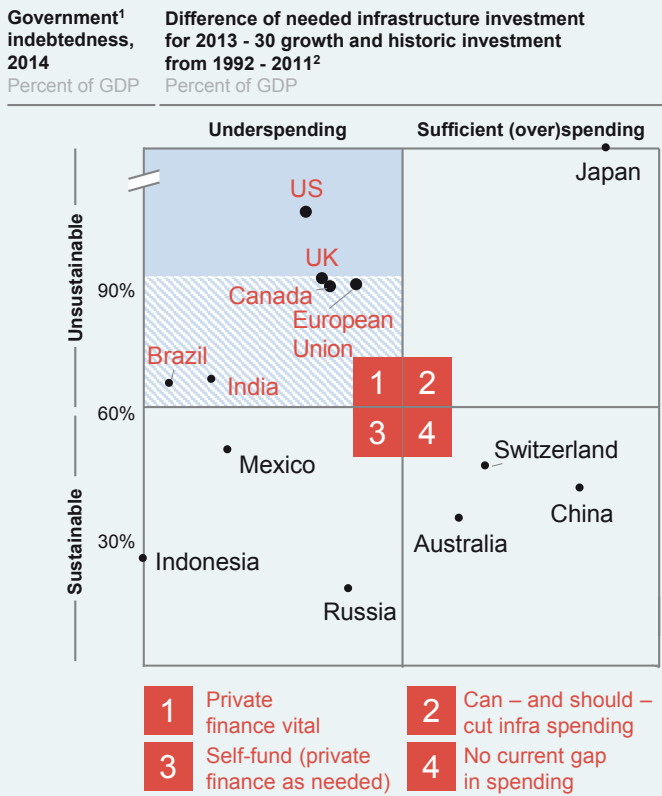
² Difference between pre-crisis (1995 - 2007) and post-crisis (2011 - 2014) private investment relative to GDP, expressed in absolute terms based on 2014 GDP of respective region in EUR

Source: European Commission Annual Macroeconomic Database; World Bank

Exhibit 2

Closing the infrastructure gap requires private investment, especially in the US, UK, and EU

Infrastructure investment and government debt of selected countries



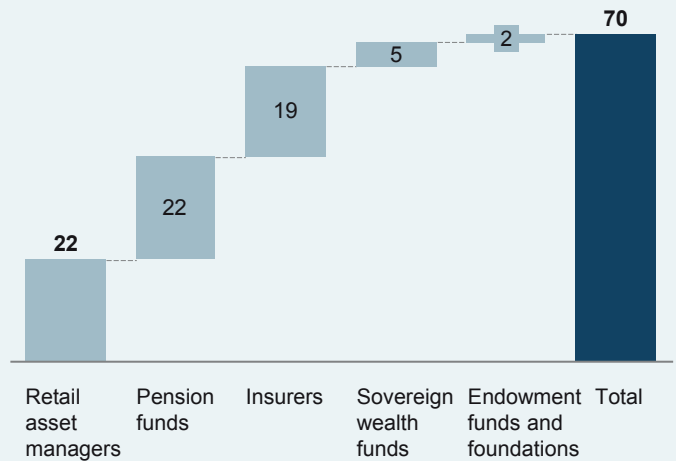
1 General government gross debt, including SDRs, currency and deposits, debt securities, loans, insurance, pensions and standardized guarantee schemes, and other accounts payable
2 Gaps relate to future growth projections, not to historic underinvestment or to growth aspirations different from projections
Source: IMF; McKinsey Global Institute

Exhibit 3

With ~ EUR 70 trillion of assets under management, LTIs manage ~ 32% of all financial assets worldwide

Financial assets under management by LTIs, 2014

EUR trillions



In 2014, financial assets under management by LTIs amounted to

~ 32% of financial assets worldwide (~ EUR 221 trillion)

~ 120% of world GDP (~ EUR 58 trillion)

> 5 times the annual output of the US (~ EUR 13 trillion)

Note: Use of average annual exchange rates USD/EUR
Source: SWF Institute; World Bank; McKinsey Global Institute & Global Asset Management

LTIs reiterate their willingness to support growth more strongly, but the current shortcomings of the financial and legal systems (lack of protection) limit their financing possibilities in some circumstances. LTIs struggle with adverse market dynamics, such as distortions in the risk-return profile of some investment assets, and with some public policy interventions, such as monetary policy, industry and market regulation, and accounting rules. For example, many LTIs would like to allocate more assets to infrastructure (which is currently below target), but a lack of appropriate public investment projects, prohibitive risk capital charges, and considerable uncertainty about retroactive government and legal changes to contract terms limit their funding possibilities.

Taking full advantage of LTIs' potential to support economic growth requires an efficient financial system, in which financial activities on three key structural levels need to work well (Exhibit 4).

First, individual savers and borrowers need unhindered access to financial markets or, more concretely, to a diverse set of relevant savings/investment and financing vehicles. Especially for savers preparing for retirement, investment vehicles must fit their level of financial literacy, and have adequate, undistorted, and transparent risk-return profiles. Borrowers require a broad range of financing possibilities to acquire funding for productive investments such as bank lending and well-developed capital markets.

Second, LTIs, banks, and other financial intermediaries are essential for ensuring the efficient allocation of financial assets among market participants. The long-term investment capabilities of institutional investors play an especially important role in addressing societal challenges such as infrastructure and pension gaps. Regulation of financial intermediaries needs to control and reduce (systemic) risks stemming from intermediation – but regulatory invasiveness should not extend beyond the necessary level. Regulation should allow for effective intermediation, keeping the administrative burden minimal and generating a level playing field for all intermediaries, while accounting for differences in the nature and risks of the various business models.

Third, the underlying capital and financial markets must be efficient to channel funds optimally from savers to borrowers. Market structure and the regulatory environment should ensure that market prices are transparent and as undistorted as possible, risks are appropriately priced, and transaction or “frictional” costs are as low as possible, as they are ultimately paid by households (i.e., savers and future pensioners) and corporations and SMEs (i.e., borrowers).



I Individual level:
Sources of funds
“Savers”

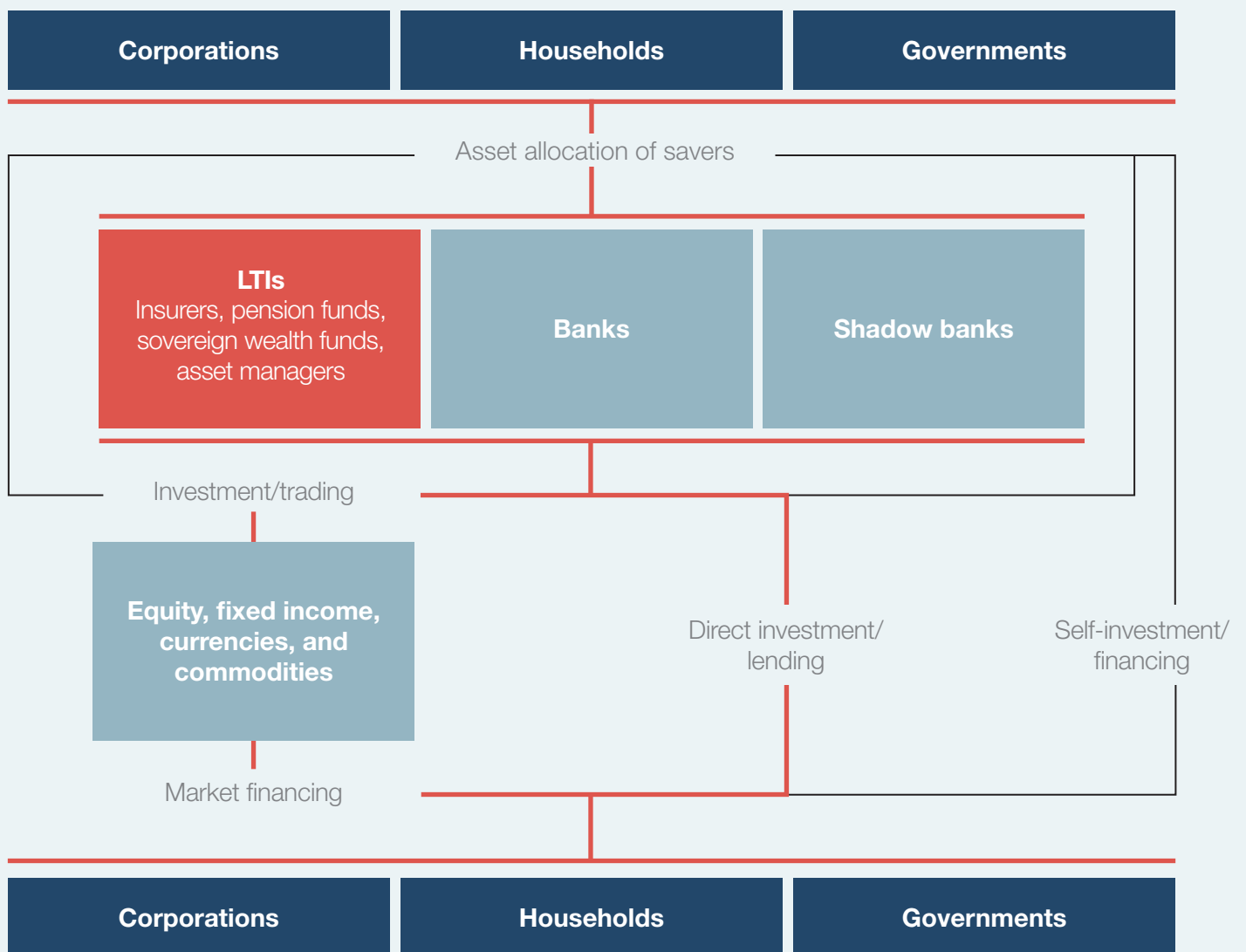
II Industry level:
Financial
intermediaries

III Market level:
Capital/
financial markets

I Individual level:
Uses of funds
“Borrowers”

Exhibit 4

A stylized view of the financial system



Main observations

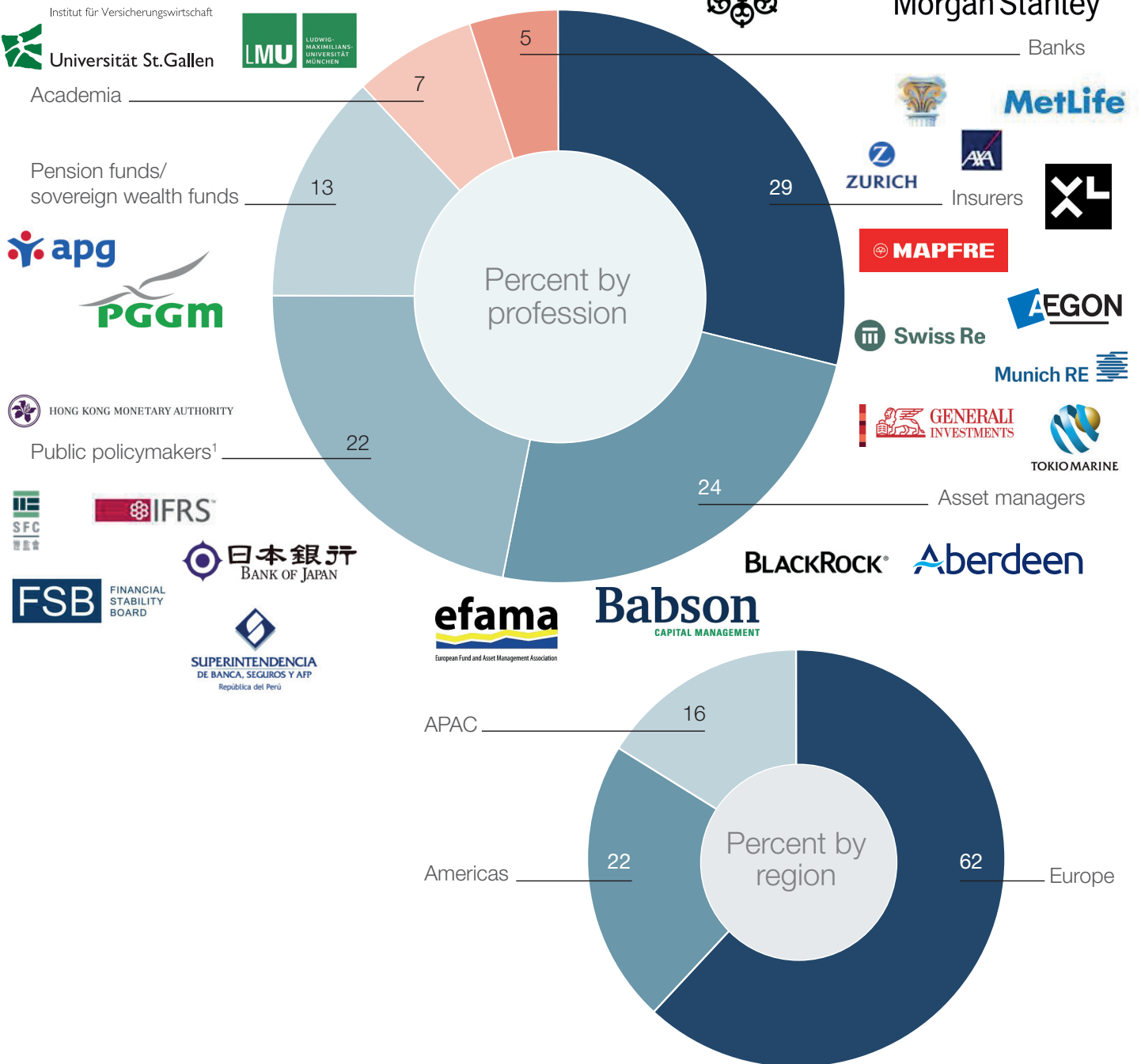
Four challenges facing long-term investors

The GAC conducted ~ 50 interviews with senior representatives of governments, regulators, academia, and the LTI community (Exhibit 5). The interviews collected thoughts from a broad, balanced group of experts on the impact of

policy conflicts in the financial system and the role of LTIs in the wake of the financial crisis, as many countries strive to rekindle growth and tackle societal challenges such as increasing pension and infrastructure gaps.

Exhibit 5

Overview of interview participants



¹ Including regulators, accounting standard setters, central bankers, and government representatives



The interviews revealed four key challenges for LTIs in the financial system and elicited recommendations on how

policymakers and LTIs can work together to harness LTIs' full potential for supporting the real economy.

1

Repercussions of the crisis – distorted risk-return characteristics and increased administrative burden limit LTIs' ability to invest

2

Policy framework for LTIs – the regulatory framework does not sufficiently reflect the business model specifics and risk profiles of different financial institutions, creating an unlevel playing field and constraining long-term investment

3

Market structure – underdeveloped corporate bond markets, liquidity risk in fixed-income markets, and suboptimal infrastructure financing conditions limit productive long-term investment possibilities

4

Interaction of LTIs and policymakers – ineffective dialogue with policymakers and tendencies towards self-centered and siloed campaigning limit the voice of LTIs in regulatory processes

1

Repercussions of the crisis – distorted risk-return characteristics and increased administrative burden limit LTIs' ability to invest

The global cost of the financial crisis and the subsequent worldwide economic recession (2008 - 12) amounted to a conservatively estimated USD 10 trillion - 15 trillion— equal to ~ 15% of the world GDP or the total annual output of the US.² It is safe to assume that the damage could have been far worse if policymakers had not taken immediate action. They moved swiftly to contain the adverse effects in the financial markets and made the economic and financial system more resilient against financial turbulence by using monetary and fiscal policy tools and establishing new regulations to reduce excessive leverage and systemic risk in the financial sector.

But the primary focus on the stability of the financial system left other policy goals, such as economic growth, unattended. Furthermore, given the unparalleled level of public policy intervention and the urgency of action, the coordination of various regulatory efforts understandably fell short. This contributed to increased complexity in the regulatory environment, sometimes triggering unintended consequences that are affecting the business activities of LTIs and increasingly run counter to other public policy goals. The growing number of regulators and their increasing and sometimes overlapping competences regarding jurisdictions and lines of business further contributed to regulatory complexity,

increasing the administrative burden and “frictional” costs in the financial system that the individual investor or saver ultimately pays (Exhibit 6).

Efforts to consolidate and harmonize regulations, within and across countries, have been underway for a long time. But such initiatives have proven fragile and their results elusive as, especially in times of stress, focus shifts to stabilizing single industries or (national) markets. Different countries' implementation of international regulations (“national finishes”) that further raises international investors' costs for regulatory compliance also impedes cross-border harmonization.

From a global macroeconomic perspective, the complex regulatory framework is not conducive to cross-border investments, which have dropped considerably since the crisis.³ The increasing regulatory complexity within and across markets causes LTIs to see limited opportunities to channel their investment funds efficiently – this adversely affects opportunities for long-term economic growth and has negative impact on LTIs' returns and those of their beneficiaries (i.e., retail savers).

2 IMF; World Bank; US Dallas FED

3 *Long-term Finance and Economic Growth*, Group of Thirty, 2013



Exhibit 6

Schematic overview of the financial regulatory landscape – recent changes since the financial crisis

- Existed before the financial crisis
- Existed before the financial crisis, but powers were extended
- Established after the financial crisis

Regulatory and standard-setting bodies

Global	G20					IASB (IFRS) ¹
	Financial Stability Board (FSB)					
	BANKING – BCBS	SECURITIES – IOSCO	INSURANCE – IAIS	PENSIONS – IOPS	ACCOUNTING – IASB	
EU	European Commission					IASB (IFRS) ¹
	ESRB					
	EBA	ESMA	EIOPA			
	ECB – SSM/SRM					
	Country banking supervisors	Country securities supervisors	Country insurance supervisors	Country pensions supervisors		
US	U.S. Department of the Treasury					FASB (GAAP) ³
	Financial Stability Oversight Council (FSOC)					
	Consumer Financial Protection Bureau (CFPB)					
	FED ²	SEC	NAIC	SSA		
	FDIC			CFTC	DOL	
	NCUA	FINRA	FIO	EBBSA		
	OCC					
State banking supervisors	State securities supervisors	State insurance supervisors	PBGC			
Other regions	National regulators and standard setters incorporating global/national rules					

¹ Standards issued by the IASB must go through the EU due process of endorsement before becoming law in the EU

² New regulatory powers also extend to the insurance industry

³ Standards issued by the FASB need to be adopted by the SEC before becoming law in the US

Source: JP Morgan Chase; McKinsey; please see glossary for a list of abbreviations (p.26)

Additionally, the sustained monetary policy of low rates and unconventional measures, such as quantitative easing (QE), contributed to further market distortions in asset risk-return profiles (e.g., those of government and corporate bonds). Of course, such a monetary policy of cheap liquidity was necessary to stabilize bank lending to the real economy – supporting postcrisis economic recovery in many countries. The provision of cheap liquidity has also calmed the stressed financial markets and helped governments manage their fiscal deficits.

But the downside of an environment of sustained low interest rates is that private and institutional investors have difficulty earning sufficient returns. Life insurers and pension funds may particularly struggle to fulfill their guarantees to policyholders. On the individual level, many policyholders and savers find the real returns on their savings at risk, possibly undermining their incentives to put money aside. If such an artificial, low-interest-rate environment persists over the long term, it will impose considerable burdens on governments. It increases the risk of poverty in old age and further weakens government incentives for structural reforms.

Recommendation

The balance of public policymaking between ensuring financial stability and facilitating economic growth requires recalibration, and the financial system needs a more cohesive policy framework.

While much new financial regulation has been passed in response to the financial crisis, a substantial share of it remains to be implemented. In this phase, it is pivotal that governments and regulators balance the objectives of financial stability and economic growth appropriately. They should, as much as possible, avoid a one-sided regulatory focus on stability that might create unintended consequences such as additional costs created in the financial system or distorted LTI asset allocation that reduces productive investments. Governments in particular should foster a more constructive dialogue among central banks, regulators, and LTIs in order to orchestrate this undertaking.

To this end, policymakers should continue to assess the impact of regulatory initiatives both before and after rules are introduced in order to thoroughly evaluate regulatory effectiveness and potential side effects. A holistic, cross-industry view will be vital. Financial market participants, such as LTIs, need to help by providing fact-based, quantitative insights into positive and adverse effects to support regulatory adjustments. They should refrain from narrow self-interested lobbying for regulatory exceptions, which is often a significant factor in driving regulatory complexity, and keep the broader picture of growth and stability for the economy as a whole in mind.

When shifting focus towards economic growth, regulators might be tempted to introduce a new layer of rules and incentives. LTIs see more potential in consolidating exist-

ing regulations and creating a more cohesive framework for the financial system, also on international levels. As a case in point, consider the EU directive on collective investment schemes (UCITS). While many countries in Asia, for example, originally considered adopting UCITS for their jurisdiction as well, the continued refinement and tailoring to specific European concerns has reduced the framework's attractiveness for other regions. Implementation in the Asian market has now become less probable – albeit its significant potential to allow for a freer flow of capital and more diversification possibilities for (retail) investors.

The different accounting standards in Europe and the US (IFRS vs. GAAP) also create an unnecessary administrative burden for LTIs, ultimately paid for by savers and borrowers.

The opportunity to improve regulatory consistency is large. A 2009 report estimated that the US insurance industry alone incurs an estimated USD 13 billion a year in unnecessary costs due to the lack of a uniform, state-based regulatory system – costs ultimately borne by policyholders.⁴ Since 2009, the US has seen a lot of regulatory action, but a lack of uniformity remains.

Regulatory simplification and harmonization, along with clear responsibility within the regulatory landscape, would help strike the right balance between stability and economic growth.

⁴ *Improving Property and Casualty Insurance Regulation In the United States*, McKinsey, 2009

2 Policy framework for LTIs – the regulatory framework does not sufficiently reflect the business model specifics and risk profiles of different financial institutions, creating an unlevel playing field and constraining long-term investment

LTIs feel that today's policy framework does not always properly reflect the differences in their business models, creating an unlevel playing field. The risks related to financial business activities (e.g., direct lending) differ substantially depending on the type of intermediary and corresponding funding structure as well as the use of financial leverage.

LTIs' leverage and liquidity risk and, hence, contagion risk for the financial system are fundamentally lower than the corresponding risks of banks. Banks engage in maturity transformation – providing credit with contract lengths of several years funded with deposit money of their customers that can be withdrawn on short notice. Banks are therefore exposed to significant liquidity/refinancing risk. Banks are also generally leveraged financially, and they are tightly connected to each other via the interbank market. The combination of significant liquidity risk, connectedness, and high leverage forms contagion, or system risk, as shocks can pass from individual institutions to the entire economy.

LTIs do not have the same financial interconnectedness (i.e., they have significantly less balance sheet exposure to each other) and typically use very little financial leverage. As “real money” investors, they have a more inherent capacity to absorb losses and thus can better weather financial shocks. They are also generally less exposed to liquidity risks, given their funding structure. Life insurers and pension funds in particular are inherently liquidity rich since their liabilities cannot be called at will. Instead of maturity transformation, they aim to match their long-term liability structure with assets that have a corresponding maturity profile (Exhibit 7).

Because the key sources of contagion differ (e.g., leverage, liquidity risk, and financial market interconnectedness), it is important that regulation is tailored to business specifics. This requires more than distinguishing regulation by industry (“name tag”), as even within one industry group (e.g., insurance), investment and funding approaches, financial interconnectedness, and degrees of global footprint differ – indicating that players have very different risk types and levels.

Regulatory (systemic) risk assessment should therefore differentiate between business models, also taking into account the underlying funding structure and leverage of the players. The Financial Stability Board (FSB) has begun to incorporate this idea into its risk assessment framework of systemically important non-bank non-insurance financial institutions (NBNIs) where the focus is starting to shift from entities to specific business activities. Moving forward, such an activity focus in regulation should extend to the entire financial sector in order to ensure fair market competition and the appropriate regulation of different players.

Recent examples show that regulatory rule-setting did not always appropriately account for these differences in business models. Since the banking system triggered the recent crisis, most new regulatory measures originated in banking. Consequently, the banking rules were a logical starting point for the regulation of other entities and have partially provided a regulatory blueprint for LTIs (e.g., globally systemic relevance of insurers) – despite the substantially different business model and risks.

Another example of business model differences being reflected insufficiently is the setting of risk capital requirements and accounting rules (mark-to-market approaches). Both have increasingly focused on market- and risk-based methodologies, using daily market data as a basis for calibration. These standards improve risk awareness, transparency, and the quality of risk management. European insurers are especially exposed and consider the new rules superior to previous standards.

But these rules also increase the short-term volatility in many LTIs' balance sheets. For example, asset cashflows of held-to-maturity strategies are only affected by default rates, not spread volatility. Still, the treatment of credit spreads in asset and liability discount curves for insurers transfers (parts of) this spread volatility into the books. Recent changes, such as the volatility and matching adjustments of Solvency II, partially address this issue.

From an economic perspective, volatility is not necessarily a problem, but it can become a problem if LTIs are forced, in extreme market circumstances, to liquidate positions even when doing so makes no economic sense. This creates biases for more short-termism and procyclical investment, especially if regulators, investors, and analysts do not take a through-the-cycle perspective on short-term volatility.

Moreover, the current calibration of some capital charges in solvency capital regimes (e.g., in Solvency II for insurers) does not reflect market prices for risks and influences LTIs' asset allocation. This advantages a (sovereign) bond-heavy portfolio, while disadvantaging equity, long-term corporate debt, and infrastructure investments.

Finally, internal factors, such as short management cycles and short-term incentive systems and business targets, encourage short-term biases among managers, which further nurture shortsighted and procyclical investment behavior.



Exhibit 7
Main differences between LTIs and banks (simplified)

	LTIs					
	Insurers	Pension funds	SWFs	Traditional AMs	Alternative AMs ⁴	Banks
Main role	Investment and retirement solutions/risk mitigation	Retirement solutions	Handling state-owned investments	Investing on behalf of 3rd parties (within mandate)	Private investments (partly active)	Creating money and credit, handling the payment system, liquidity transformation
Investment horizon	Asset duration avg. 7 years, liability duration avg. 11 years ¹	Matching long-term liability profile of avg. 14 years ²	Long-term public interests (e.g., GDP diversification)	Per se not predetermined, driven by mandate but typically medium-/long-term customer base (e.g., pension plans, retail customers)	From very short- to long term; “active control”	Short/medium term: bank loans; engagement in maturity transformation
Funding/outflow risk	← Very long-term funding with limited outflow risk →		Long-term public funding	On average medium- to long-term funding but outflow risk (outside DB/DC business)	Often medium- to long-term funded	Mainly short-term funded (deposits)
Leverage	←———— Low (“real” money) —————→				Medium to high	High
Investment mechanism	← Investments on own balance sheet ³ →			Mostly intermediation only	Intermediation often combined with own co-investment	Investments on own balance sheet
Revenue source	← Share in total return (dep. on surplus rules) (traditional life/DB) →		Absolute return	Fees (mostly commission/performance but not advisory fees)	Fees (incl. performance fees/carry)	Spread earnings
Business model inherent risk	← Asset-liability mismatch (not fulfilling guarantees) →			Liquidity mismatch		Maturity mismatch (bank run)

1 Based on European insurer sample

2 DB pension funds

3 Except unit-linked in case of insurers

4 Hedge funds, PE funds, etc.

Source: World Economic Forum; McKinsey



Recommendation

Efforts to better account for differences in business models, funding structures, and leverage ratios in regulation need further reinforcement, facilitating long-term investment and economic growth.

To ensure that regulation is tailored appropriately to business models, LTIs should engage in a fact-based dialogue with regulators about their business models. They should explain the nature and risks of their business activities, instead of just lobbying. This would encourage a review of systemic importance and the contagion potential of various business models.

As a case in point, LTIs (especially insurers and pension funds) need to demonstrate to regulators the absence of liquidity risk, even in their nontraditional businesses, such as lending, due to the difference in funding structure compared to banks. This implies less contagiousness, which a more differentiated view on systemic relevance should reflect.

Regulators should also recalibrate and more granularly differentiate risk charges to eliminate biases in risk regulation that could impair LTIs' ability to support productive long-term investments such as corporate or infrastructure financing. Reviewing the risk charges for government bonds and infrastructure investments was the right decision. Risk charges for illiquid assets in general might need further differentiation. Once Solvency II has been introduced, all capital requirements will require regular reevaluation and recalibration.

Policymakers also need to find ways to reduce short-term and procyclical thinking. Addressing this issue does not imply a fundamental rule change. European insurance regulation, for example, should maintain mark-to-market accounting and Solvency II. However, the current accounting standards (GAAP, IFRS) and regulatory risk capital calculation in particular should more strongly reflect the long-term funding structure of LTIs in order to minimize the current short-term volatility in LTIs' balance sheets. Countercyclical risk capital thresholds in Solvency II are one step in the right direction.

Accounting standards should incorporate new elements to decrease LTIs' sensitivity to short-term market volatility and to encourage long-term investment. One possibility is introducing a new category of "assets held long term" with accounting notes combining mark-to-book accounting of this asset class with mandatory complementary reporting of market values.

Another possibility is encouraging institutional investors to publish two reports, one based on mark-to-market and the other on mark-to-book accounting in order to increase transparency and address the different needs of various stakeholders. Of course, the potential costs of such a change would require careful evaluation and comparison with the estimated benefits.

As they are currently exposed to artificial balance sheet volatility, LTIs should educate investors and analysts on taking a through-the-cycle perspective when evaluating financial performance. More importantly, LTIs should avoid emphasis on the short term in their internal governance and managerial incentive systems. Many senior executives today are seeing increased short-term pressure on financial performance, despite their belief that a long-term approach to business decisions is a key factor in company performance. Ways to strengthen long-term thinking include spending more time developing a compelling long-term business strategy, clearly communicating this strategy to investors, and increasing the share of long-term performance metrics.⁵



⁵ *Focusing Capital on the Long Term*, initiative led by McKinsey and Canada Pension Plan Investment Board

3 Market structure – underdeveloped corporate bond markets, liquidity risk in fixed-income markets, and suboptimal infrastructure financing conditions limit productive long-term investment possibilities

Given the recent tightening in banking lending, fostering economic growth will require careful review of the structure of key capital markets in order to ensure that corporations and SMEs receive sufficient financing.

This is a particular concern outside the US. Credit markets tend to be underdeveloped in most emerging markets and in Europe, where companies obtain credit primarily through bank lending, rather than capital markets (Exhibit 8). Too narrow a scope of available market financing methods for corporations and SMEs, including limited securitization of loans, limited standardization of bonds, and legal restrictions on direct lending by LTIs, often constrains market funding for companies and limits growth potential in many economies.

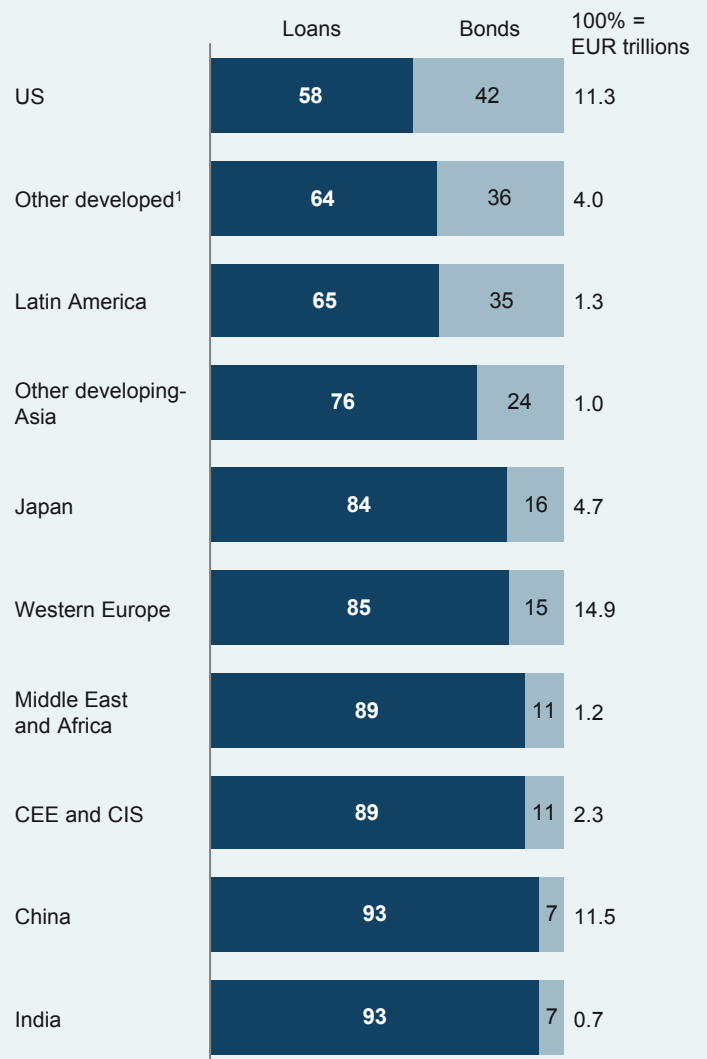
Investors, particularly LTIs, would also benefit from better developed corporate credit markets. The long-term liabilities typically held by life insurers and pension funds would match the long-term investment needs of corporations and SMEs well.



Exhibit 8

Corporate bond financing is more pronounced in the US than in the rest of the world

Debt financing of nonfinancial corporations per region
Percent, year-end 2013



¹ Australia; Canada; Hong Kong, China; Republic of Korea; New Zealand; Singapore; Taiwan

Source: McKinsey Global Institute



Since the crisis, the effects of the expansive monetary policy that led to a “hunt for yield” by investors and compressed credit spreads have further distorted global fixed-income markets. Cheap money and the hunt for yield have contributed to a record-high issuance of corporate bonds, while average credit quality has fallen and credit risks have increased. At the same time, banks have reduced their market-making activities in response to tighter bank regulation.

Liquidity in fixed-income secondary markets, which rely on banks’ market making, has dropped noticeably. Thus, many market participants see a liquidity crunch as “an accident waiting to happen” if macroeconomic conditions tighten (Exhibit 9). While multiple factors may contribute to the increased liquidity risks (e.g., market structural changes such as electronification and the advent of high-frequency trading⁶), tighter banking regulation certainly did not alleviate the liquidity issues in fixed-income markets.

Infrastructure financing suffers from a mismatch between supply and demand. The need for financing to build and maintain public infrastructure in the coming years (investment gap)⁷ is huge, while the infrastructure allocation of many institutional investors lags targets (Exhibit 10).

Key issues are an insufficient infrastructure project pipeline and shortcomings in the investment framework that mean missed development opportunities for society. Too few investment opportunities that have an appropriate project structure and risk-return characteristics for private financing are generated. The large ticket size of many infrastructure investments and lack of a tradable, global infrastructure asset class discourage funding, particularly by smaller LTIs.

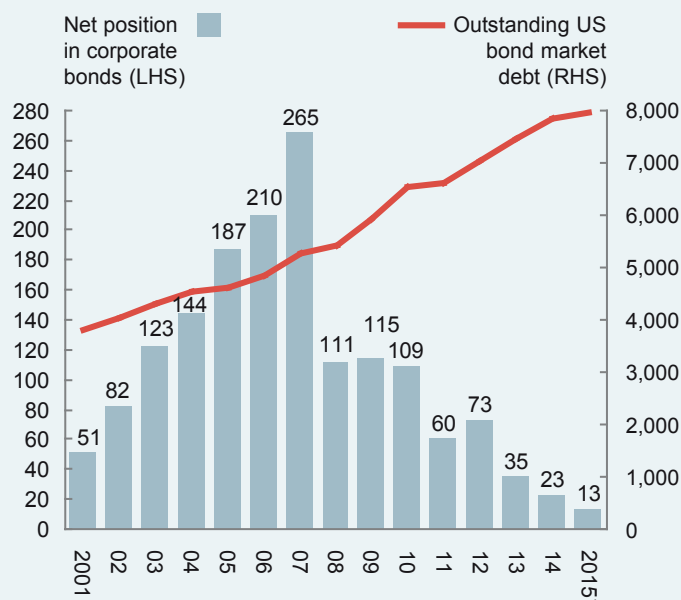
Moreover, standardization or comparison of single assets and price transparency are often very low (e.g., low reporting standards and partially confidential auctions), making the complexity of many investment opportunities too high for unspecialized investors. To facilitate financing, they would have to build dedicated in-house expertise, especially underwriting skills.

Finally, the risk of retroactive government and legal changes to the contractual terms – as in recent incidents, e.g., in Norway, Italy, and Spain – erodes investors’ trust and appetite.

Exhibit 9

Dealers’ net positions in US corporate bonds collapsed, while issuance soared

Corporate bond volumes of US dealers
USD billions



¹ Outstanding amount 2015 refers to Q1 2015; net position 2015 refers to August 19, 2015

Source: New York FED; SIFMA

⁶ *Regulation and Liquidity Provision*, remarks at the SIFMA Liquidity Forum, New York City, by William C. Dudley, President and CEO, New York FED, September 2015

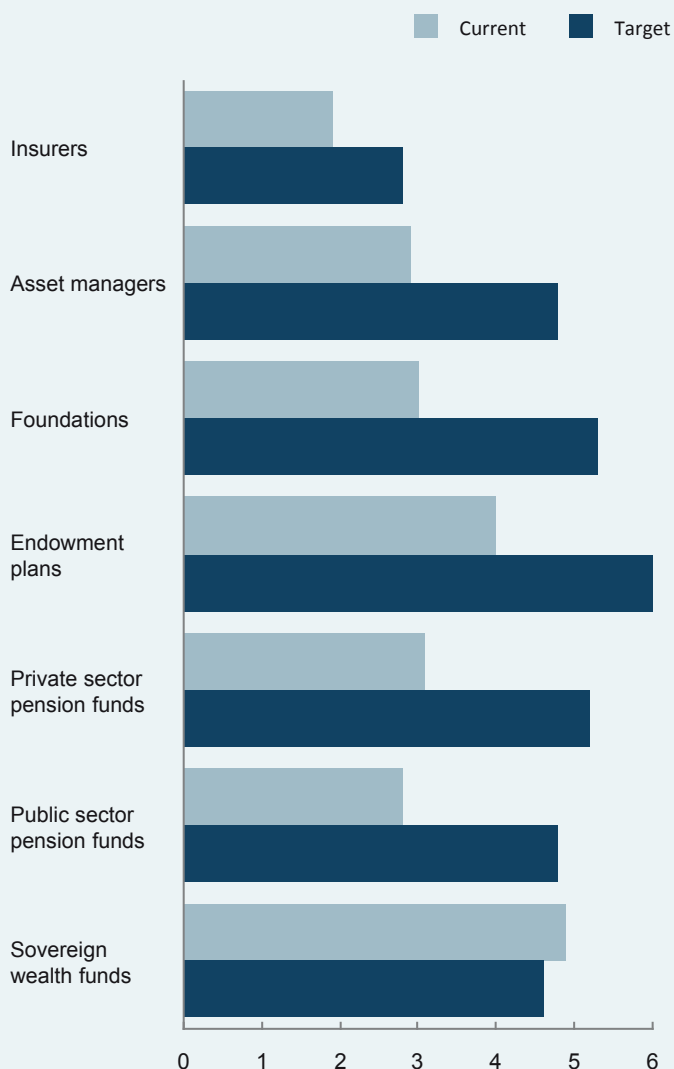
⁷ In 2013, McKinsey estimated the need to invest USD 57 trillion in building and maintaining infrastructure worldwide between then and 2030. *Infrastructure productivity: How to save USD 1 trillion a year*, McKinsey Global Institute, January 2013

Exhibit 10

Overall, LTIs see their asset allocation to infrastructure financing behind target

Average current vs. target infrastructure asset allocation of LTIs, 2013

Percent of total AuM



Source: Preqin infrastructure online

Recommendation

Corporate credit market structures require enhancement, and private infrastructure financing possibilities need improvement to foster productive long-term investments for society.

Fixed-income markets. Regulators, governments, and industry participants should increase their joint efforts to strengthen fixed-income financing for corporations and SMEs. They should enhance specific financing measures such as the creation of a strong, standardized framework for securitization of corporate loans, standardization in bond financing, and the encouragement of exchange trading of financial instruments.

Take securitization as an example. A strong framework for securitization would allow banks to extend their credit lines to corporates and SMEs and also offer LTIs attractive investment opportunities, channeling their funds to support productive corporate investment. In many regions, however, one central issue facing securitization is regulator and investor skepticism, rooted in the precrisis toxicity of many securitized products. Even in regions where securitization remained stable through the crisis, trust is rather low. Hence, a framework with stronger standards that increases transparency and, more importantly, ownership of risks and accountability of the product manufacturers (“skin in the game”) is central to strengthening the market.

Overall, the enhancement of available market financing instruments could counteract potential liquidity dry-ups in fixed-income secondary markets. Of course, efforts focused on standardizing corporate bond financing in particular should take the requirements and interests of corporations and SMEs into account. A comprehensive approach to enhancing fixed-income market financing would also include the education of SMEs on financial management.

Infrastructure financing. Governments should intensify their efforts to facilitate private infrastructure investment, primarily by stimulating the project pipeline, increasing the number of attractive investment opportunities, and ensuring a stable and transparent investment framework. Governments and LTIs should engage in a constructive dialogue, especially for large infrastructure projects, to increase the transparency of project risks and should build expert capabilities to facilitate private long-term funding. The introduction of a bond structure with smaller ticket sizes would give smaller investors access, and more standardization would increase tradability. Creating independent third-party rating agencies specialized in public infrastructure could solve the problem of capabilities (e.g., underwriting).

4 Interaction of LTIs and policymakers – ineffective dialogue with policymakers and tendencies towards self-centered and siloed campaigning limit the voice of LTIs in regulatory processes

One of the potential root causes of the three challenges previously mentioned might be that LTIs and policymakers do not interact and collaborate effectively.

LTIs admit that they are not very successful at making their concerns heard in public policymaking processes and do not connect sufficiently with policymakers. Whether justified or not, LTIs see banks as more effective in regulatory processes, traditionally having a strong track record of interaction with regulators. LTIs perceive banks as having greater influence, especially in industrywide governance bodies that often have overproportional representation of (central) bankers (e.g., FSB and ESRB). This is of particular importance because many politicians and supranational organizations (e.g., G20, OECD, and the UN) tend to approach regulation through these bodies. Furthermore, in the eyes of insurers, the IAIS does not receive the same attention as the BCBS.

The community of LTIs also lacks a convincing overarching industry association comparable, for example, to the IIF. Though LTIs devote substantial resources to making their voices heard in regulatory processes, coordination across players, countries, and platforms is still insufficient, especially compared with the industry coordination achieved in the banking sector.

LTIs drive many efforts to approach public policymakers in their business-model-specific silos, instead of presenting industrywide, fact-based analyses and delivering empirical evidence supported by independent academic research. LTIs too often campaign for their idiosyncratic needs and interests, rather than presenting an aligned LTI perspective that emphasizes the beneficial role they play for society as a whole.

All these factors serve to hamper dialogue and collaboration between LTIs and public policymakers. As a result, regulators do not always acknowledge LTIs' beneficial role, and LTIs struggle to understand regulators' views and motivations.





Recommendation

LTIs should increase their coordination and fact-based involvement in regulatory processes, and regulators should solicit more advice from LTIs.

Public policymaking processes require continuous improvement and learning by all involved parties. Acknowledging this gives regulators scope to revisit existing regulations in light of the changing environment and encourages LTIs to constructively support policy changes and give regulators the benefit of the doubt.

Regulators and LTIs need each other to improve outcomes continuously. Regulators need LTIs' practical knowledge to better assess the potential effects of rules on LTI business models and to develop appropriate rules. Many regulators say that they would welcome more proactive, fact-based involvement of LTIs. This involvement would foster a more open, unbiased, and collaborative dialogue and ultimately improve the regulatory processes.

When governments and regulators seek advice on long-term issues, such as strengthening capital-market-based financing or closing the infrastructure investment gap, they should reach out more actively to LTIs. In order to support this process, LTIs should collaborate across the narrow boundaries separating their business models. They should define their common needs and jointly address the big issues in regulatory processes with one voice.

One way to accomplish those goals might be to create an association involving all long-term-oriented investor types to establish a key contact for governments and regulators in addition to the already well-organized banks. Such collaboration would help LTIs focus on their shared "big picture" and overarching societal impact, rather than on idiosyncratic interests, when approaching regulators and governments. LTIs could also play a more active educational role in the broader public debate – with or without a new industry association.

Conclusion and call to action

In the aftermath of the financial crisis, increased public policy focus on financial stability was essential to abating the crisis. However, as many countries (especially in Europe) are struggling to stimulate economic recovery postcrisis, policy focus needs to shift towards fostering economic growth. LTIs, governments, and regulators have substantial opportunities to improve the financial system and strengthen their economies' path to growth.

LTIs should:

- **Collaborate across the narrow boundaries separating their business models** to participate in the public policy process, create a single voice on common needs and big issues, and play a more active role in the public debate (e.g., through a new association for all LTIs). Of course, different LTIs also have different interests, but they still have a lot in common and should strive to find their common denominator.
- **Engage in dialogue with policymakers**, sharing the nature and risks of their business activities, and support rule-making by providing fact-based insights into the adverse effects of certain policy measures.
- **Change the content of their engagement** with regulators and governments to focus more on the overriding societal interests than on idiosyncratic needs.
- **Avoid a short-term orientation in their internal governance** and incentive systems and educate investors and analysts on the (ir)relevance of short-term volatility to long-term-oriented investors.

Regulators should:

- **Consolidate and harmonize their rule books wherever possible**, also tapping LTI expertise to identify inconsistencies and needs for harmonization.
- **Continue to assess the impact of regulatory initiatives both before and after rules are introduced** in order to thoroughly evaluate regulatory effectiveness and potential side effects.
- **Adopt a more activity-specific approach to regulation** recognizing the differences in LTI business models and in corresponding risks for the financial system.

Governments should:

- **Orchestrate the interplay of public policy interventions**, ensuring an appropriately balanced focus on the overarching objectives of economic growth and pension security, and foster constructive dialogue among central banks, regulators, and LTIs.
- **Involve LTIs more actively in strengthening capital-market-based financing**, closing the infrastructure gap, and assessing policies.
- **Intensify efforts to facilitate private infrastructure investment**, primarily by stimulating the project pipeline, increasing the number of attractive investment opportunities, and ensuring a stable and transparent investment framework.

Together, LTIs, governments, and regulators should:

- **Cultivate open, trusted, and constructive interactions**, acknowledging that the public policymaking process requires continuous learning by all involved.
- **Foster the development and resilience of fixed-income markets**, especially the development of corporate bond markets (e.g., through balanced standardization).
- **Enhance private infrastructure financing activities** by fostering dialogue, especially in large infrastructure projects, to increase project transparency and establish expert capabilities (e.g., underwriting).

Although no easy task, change is possible, and the best way to begin is by strengthening the ground shared by policymakers and LTIs. Governments, regulators, and LTIs should come together to address the issues outlined in this document.

Davos 2016 can be a starting point for a new way of collaborating.

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Oliver Bäte
CEO Allianz SE, GAC Chair



Anne Richards
CIO Aberdeen Asset Management, GAC Vice Chair

The Global Agenda Council on the Future of Insurance and Asset Management



**Oliver Bäte
(Chair)**
Chief Executive Officer
Allianz SE



**Anne Richards
(Vice Chair)**
Chief Investment
Officer
*Aberdeen Asset
Management*



Francis Bouchard
Managing Director
*Hamilton Place
Strategies*



Santiago Casanueva
Board Member
Grupo CP



Stephen Cross
Chief Innovation
Officer
Aon



Martha Deevy
Senior Research Scholar and
Director
*Stanford Center on Longevity
Stanford University*



Gay Huey Evans
Independent Non-
Executive Director
Aviva



Chris Ford
Global Head of
Investment
Towers Watson



Andreas Hackethal
Professor
*Goethe University
Frankfurt am Main*



Sony Kapoor
Managing Director
Re-Define



Alice Law
COO and Executive
Director
*Mandatory Provident
Fund Schemes Authority*



Thomas Leonardi
Senior Adviser
Evercore Partners



Alison Martin
Group Management
Board Member
Head of Life & Health
Swiss Re



Michael J. Morrissey
President and Chief
Executive Officer
*International Insurance
Society*



Dana Muir
Professor
*Ross School of
Business
University of Michigan*



Jacob Rosengarten
Chief Enterprise Risk
Officer
XL Group



Yves Stevens
Professor
*University of Leuven
(KU Leuven)*



Vanessa Wang
Managing Director
Asia-Pacific
Head of Pensions
Citi

Glossary

Abbreviations

AuM	Assets under management	IIF	Institute of International Finance
BCBS	Basel Committee on Banking Supervision	IMF	International Monetary Fund
CEE	Central and Eastern Europe	IOPS	International Organisation of Pension Supervisors
CFPB	Consumer Financial Protection Bureau	IOSCO	International Organization of Securities Commissions
CFTC	Commodity Futures Trading Commission	IRS	Internal Revenue Service
CIS	Commonwealth of Independent States	LTI	Long-term investor
DB	Direct benefit	NAIC	National Association of Insurance Commissioners
DC	Direct contribution	NBNI	Non-bank non-insurance financial institution
DOL	U.S. Department of Labor	NCUA	National Credit Union Administration
EBA	European Banking Authority	OCC	Office of the Comptroller of the Currency
EBSA	Employee Benefits Security Administration	OECD	Organisation for Economic Co-operation and Development
ECB	European Central Bank	OTS	Office of Thrift Supervision
EIOPA	European Insurance and Occupational Pensions Authority	PBGC	The Pension Benefit Guaranty Corporation
ESMA	European Securities and Markets Authority	PE	Private equity
ESRB	European Systemic Risk Board	SDR	Special drawing rights
FASB	Financial Accounting Standards Board	SEC	U.S. Securities and Exchange Commission
FDIC	Federal Deposit Insurance Corporation	SIFMA	Securities Industry and Financial Markets Association
FED	Federal Reserve System	SMEs	Small and medium-sized enterprises
FINRA	Financial Industry Regulatory Authority	SRB	Single Resolution Board
FIO	Federal Insurance Office	SRM	Single Resolution Mechanism
FSB	Financial Stability Board	SSA	Social Security Administration
FSOC	Financial Stability Oversight Council	SSM	Single Supervisory Mechanism
G20	Group of Twenty	SWF	Sovereign wealth fund
GAAP	Generally accepted accounting principles	TPR	The Pensions Regulator
GAC	Global Agenda Council	UCITS	Undertakings for Collective Investment in Transferable Securities
IAIS	International Association of Insurance Supervisors	UN	United Nations
IASB	International Accounting Standards Board		
IFRS	International Financial Reporting Standards		



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World Economic Forum
91-93 route de la Capite
CH-1223 Cologny/Geneva
Switzerland

Phone: +41 (0) 22 869 1212
Fax: +41 (0) 22 786 2744

contact@weforum.org
www.weforum.org