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The impact of regulation

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The chief financial and risk officer of APG, Angelien Kemna, believes pension funds and regulators must work together to foster opportunities for long-term investment while ensuring stable, sound, and safe financial markets.

Pension funds can play an important role in fostering long-term investment and economic growth. While banks continue to withdraw liquidity from the capital markets by making fewer loans, pension funds and their asset managers are well suited to fill that funding gap. Because our mandate is to fund the retirements of workers who may not be leaving the workforce for decades, we are able and willing to make very long-term investments. A long time horizon fits both the large scale and global nature of our operations and our fiduciary responsibility. More important, maintaining a long-term perspective benefits our pensioners, in whose interest we act. For these reasons, we strongly support the current global efforts to stimulate long-term investment.

It is, however, not only a matter of ability and willingness. We need to create the right incentives and at the same time remove barriers that constrain long-term investment. Unfortunately, regulation often forms one of those barriers. Obviously, regulation is vitally important: it serves as a traffic officer in the crowded streets of the financial markets. When drafted and applied correctly, it can be an effective tool for creating financial stability and restoring and maintaining confidence in the financial markets. When it functions to enable long-term investment, it can pave the way for citizens to meet their future financial needs.

But when regulations have the unintended effect of discouraging or even prohibiting long-term investment, they need to be identified and eliminated. Over the past few years, an enormous number of new rules have been created in reaction to the global financial crisis. In many cases, these rules have been too wide ranging. Failure to appropriately tailor regulations can close off opportunities to make long-term investments that could be widely beneficial. For example, new margin requirements for derivatives are meant to reduce systemic risk. Pension funds are highly creditworthy institutions that pose little or no such systemic risk to the financial markets. Forcing them to set aside assets for collateral purposes in the same manner as a bank or hedge fund does not make sense, and it results in a direct loss of long-term-investment opportunity.

Categorizing the impact of regulation on long-term investment

The impact of regulation on long-term investment is a complex matter. This is not only due to the fact that such investments involve a variety of products, market players, and jurisdictions. It is also because the inhibiting effect of regulation is often difficult to see and to quantify. To address this issue, we tend to distinguish different categories of regulatory impact on long-term investment in our discussions with regulators and supervisors.

The rules that encourage long-term investing (positive impact) are to be separated from those that discourage it (negative impact). Both forms of impact can either be direct or indirect. We classify rules that apply to actual long-term-investment products or strategies as having a direct impact. Rules that apply to other levels, such as investors, or to other products or parts of the market can also impact the ability or willingness to engage in long-term investment. We call this the indirect impact of regulation. That results in four categories of impact: direct and indirect positive impact and direct and indirect negative impact.

The problem is not only with the regulations that exist but also with the regulations that do not exist. In circumstances where regulation could have a positive impact on long-term investment but is lacking, it needs to be created. This goes for both the direct and indirect forms of positive impact. For example, standardization of regulations relating to covered and green bonds and cross-border investment through real-estate investment trusts would encourage more long-term investment. In a more indirect way, a general regulatory push for increased availability of long-term-investment projects and harmonizing of local insolvency regimes would also have a positive effect. We elaborate on these examples below. Failure to fill existing regulatory gaps will ultimately depress long-term investment.

Prominent examples of direct negative impact include proposed securitization regulations and rules on asset-based capital charges. These regulatory initiatives have the opposite effect of what we need: they hamper long-term investment. Indirect negative impact is more hidden in nature and thus less visible. Nonetheless, it can be just as important as direct negative impact. This is particularly true if the rules result in investors having fewer funds available for long-term investment. Margin requirements for derivatives transactions and the increase in banking costs that are passed on are crucial examples of indirect negative impact of regulation.

Negative indirect impact of regulation has taken a back seat in long-term-investment discussions. A report issued by the Financial Stability Board (FSB) in September 2014 on relevant regulatory long-term-investment factors¹ confirms this view. In its report, the FSB concludes that empirical evidence suggesting that regulatory reforms have had material adverse effects on the provision of long-term financing is lacking. In its continued search for data, the FSB then formulates a set of

¹ Update on financial regulatory factors affecting the supply of long-term finance: Report to G20 Finance Ministers and Central Bank Governors, Financial Stability Board, September 16, 2014, financialstabilityboard.org.

key indicators that could be taken into account. These indicators focus on existing capital flows and sources of funds. But this is only part of the picture. The funds not invested need to be mapped as well. If not, the indirect negative effects of regulation on long-term investment could become the assassin of long-term-investment growth.

First steps for regulations that encourage and support long-term investment

Understanding the four kinds of impact can help bring about rules that safeguard markets while maximizing the opportunity for long-term investment. We offer specific examples for each category below. Although these examples are not exhaustive, we believe they offer good starting points for taking action toward regulatory improvement. In addition, they may help inform thinking in general on the different ways regulation can encourage or inhibit long-term investment.

1. Direct positive impact: Standardize rules across jurisdictions

Standardizing the rules regarding covered and green bonds would be a straightforward way of creating direct positive impact. Currently, covered bonds, which are backed by a dedicated pool of assets, are subject to regional and even bank-specific rules. Regulators and investors should work together to create a global level playing field. In particular, standards should be formulated for overcollateralization, haircuts, valuation, the legal position of bondholders, and the treatment of residual debt. In addition, regulators and the industry should work to create common accounting standards for bondholders, as well as clear collateral requirements. Standards should include a requirement that covered bonds be rated by at least two rating agencies. Similarly, green bonds, which could be a powerful force for mobilizing capital for projects with environmental benefits, must be supported with effective regulation that mitigates the risk of greenwashing, or the unjustified appropriation of environmental virtue. Failure to formulate effective regulations will dampen the growth of this potentially beneficial market.

Real estate, too, should be an important asset class for long-term investors. To that end, we would welcome the introduction of EU-based real-estate investment trusts, which could be used to facilitate cross-border real-estate investments, but again, they must be supported with effective and standardized rules.

2. Indirect positive impact: Tailor the rules to the investor

One barrier to long-term investment is a shortage of long-term-investment projects. Even taking market-generated and government projects together, there are simply not enough opportunities. There should be a broad assessment of how to stimulate the demand side of long-term investment through supporting regulation. Part of that assessment should take into account risk-return

profiles and other relevant investment criteria for large institutional investors. The World Economic Forum's Infrastructure Investment Policy Blueprint² could provide pointers. As we have publicly stated,³ to facilitate investing for pension funds and other large investors, governments must ensure clear and stable regulations. This should include eliminating fossil-fuel subsidies, higher prices for CO₂ emission rights, and increased support for research into cleaner energy, to make investments more attractive to pension funds and allow them to meet their sustainability goals.

Discrepancies in local insolvency laws form a powerful indirect impediment to long-term, cross-border financing, especially within the European Union. These discrepancies create uncertainty and, therefore, risk in credit-financing transactions. They can also lead to excessive price fluctuation, especially in the case of default.

3. Direct negative impact: Distinguish among levels of risk in similar investments and investors

The (proposed) regulatory framework for securitization transactions has had a direct negative impact on investment behavior. Solvency II and Basel III proposals and resulting uncertainty about capital charges and liquidity treatment for securitizations have reduced investors' appetite to invest in this asset class. Securitized assets are an appropriate investment for pension plans, assuming they are properly structured and of good quality. They allow pension plans to contribute to the financing of real economy assets such as residential houses, consumer-loan leases, and loans to small and medium enterprises. There seems to be recognition today that the securitization markets need to be revived. In resetting the regulatory framework, however, special care must be taken to avoid unintended consequences. Rule makers must acknowledge that not all securitizations carry the same level of risk and make efforts to avoid unduly burdensome regulations.

Another area of direct negative impact concerns asset-based capital charges. Capital requirements for specific asset classes imposed by Solvency II will limit the amount of capital available for long-term investment. Here again, regulatory measures should take into account the varying risk profiles of different types of investors.

4. Indirect negative impact: Avoid rules that unintentionally divert cash from long-term investment

There are numerous examples here. Current regulation of over-the-counter derivatives has, for instance, an indirect negative effect on the ability to contribute to long-term investment, as the rules reduce available funds. Measures like the European Market Infrastructure Regulation result in increased allocation to high-quality government bonds and cash for collateral purposes. Since returns on government bonds are and will continue to stay low, such measures force a deviation from an optimal investment mix. Derivative collateral requirements, whether imposed

² *Infrastructure Investment Policy Blueprint*, World Economic Forum, in collaboration with Oliver Wyman, February 2014, weforum.org. The blueprint contains a practical set of recommendations for governments on attracting private capital for infrastructure projects while creating clear social and economic value for their citizens.


³ Angelen Kemna, speech at the United Nations Climate Summit, New York, September 23, 2014.

by regulation or by central clearing houses, can have a pro-cyclical effect in distressed markets by forcing fire sales of assets. Scarcity of eligible collateral will then have serious liquidity—and thus long-term-investment—consequences.

The increased banking costs that result from new regulatory measures are another source of indirect negative impact. Those costs are passed along to clients, including pension funds, once again reducing the amount available for long-term investment and forcing pension funds and other clients to pay the price for a crisis they did not cause. The net stable funding ratio, created by the Basel Committee on Banking Supervision, could prove to be yet another source of negative impact, since the rules would make it much more expensive to provide for certain equity products that are frequently used by pension funds.

In the global debate on ways to enhance long-term investment, pension funds have correctly been identified as a potential source of nonbank funding. Executed correctly, regulation can stimulate our ability to engage in long-term investment. Done poorly, it can have the opposite effect. Care must be taken to avoid regulation that results in constraints on long-term investment in both direct and indirect ways. The serious problem of indirect negative impact, in particular, tends to be overlooked in this debate.

In general, the unintended consequences of regulation must be avoided at all times. The total impact on long-term investment of all individual pieces of regulation—plus how these pieces add up and affect one another—must be understood. In addition, rules should be appropriately tailored for different market participants. Unnecessarily broad rules cause needless constraints and ultimately a loss of return for pensioners.

For the long-term-investment debate to be effective, all forms of impact must be analyzed and carefully considered. This is not an easy job but one that must be undertaken to successfully encourage long-term investment. We are here for the long term, as are the global regulators and supervisors. It is our hope that with a joint effort, we can make sure that regulatory initiatives create stable and sound financial markets without diminishing the opportunities for meaningful long-term investment. 

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