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The situation of institutional investors is critical

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ABSTRACT

This contribution is the current modification of the environment for institutional investors on the financial markets, especially the consequences of the attempt to solve the financial crisis through the massive fiscalisation of losses and subsequent therapy of quantitative easing. The existing instruments of monetary policy are becoming ineffective and some of the hitherto valid paradigms of the relationship between savings and investments are losing their force. In a situation in which the yield levels of instruments are hovering about technical zero, the situation of institutional investors is becoming complicated. The state of financial markets indicates the low effectiveness of the current strategy of state intervention in the form of rigid regulation. The question arises: is there an alternative in the form of reduced impact of the regulatory interventions of the state and supranational institutions on the financial markets and institutional investors and a return to greater spontaneity on the markets?

KEYWORDS : Quantitative easing, excess liquidity, relationship between savings and investments, strategies of institutional investors, regulation

Introduction

The global economic world is recovering only very slowly from the troubles which began with the financial crisis of 2007, which eventually spilled over into a crisis of the real economy and, finally, a debt crisis. Now, eight years since the start of the crisis, we must conclude that the state of the world economy and, by extension, the European economy, has not improved much and, indeed, in some respects has deteriorated.

New environment

The methods used to deal with the financial crisis, a crisis which threatened to lead to a collapse of the global financial system, that is, an unprecedented massive fiscalisation of losses and the subsequent therapy using an increase in liquidity in the economy through quantitative easing, totally changed the existing theoretical economic paradigms. The current economic world is displaying the symptoms of a transition through long-term transformation and considerable metamorphosis.

In this completely new environment, the traditional tried and tested instruments of financial and monetary policy are failing, and the axioms about the relationship between savings and investments are ceasing to be valid. In Europe, the situation is further complicated by the bureaucratic workings of the increasingly integrated EU and, in particular, by strong political pressure to preserve the single currency of the Eurozone, although the economies of the member states which use the Euro display increased heterogeneity which is virtually incompatible with a single currency. The level of indebtedness has worsened considerably since the start of the crisis to the point where a repetition of the fiscalisation of losses that took place in 2008 is not possible with today's levels of debt.

In this environment of excess liquidity in the financial sphere, we learn from the pronouncements of renowned bankers that money has no value and that banks are being forced to close their clients' accounts. The yield of conservative financial instruments is at technical zero, and central bankers, in order to stimulate economic growth, or at least a semblance of growth, are opting for quantitative easing, a controversial tool which many experts liken to dancing on a high wire.

If we also take into account the unprecedented shocks to the exchange rates of the Euro, Ruble, Czech Crown and even the Swiss Frank, one of the last bastions of currency stability, and the volatility of the prices of precious metals and commodities etc, it is clear how extraordinarily complicated the situation is becoming for institutional investors in the economy – banks, insurance companies and pension funds. In the course of their activities they accumulate the temporarily disposable resources of their retail clients, and these resources are then offered on the financial markets to the issuers of securities to be used to promote economic growth and also to appreciate in value.

Problem of bond securitization

Among these investors, life insurance companies and pension funds have a special status as they have to pay exceptional attention to the security of the financial instruments in which they invest their clients' temporarily disposable resources. Until 2007 the most suitable instruments for that type of institutional investor were state securities or the bonds of blue chip companies and financial institutions with an A-rating from reputable ratings agencies. Those instruments displayed a high level of security and were certain to produce a positive yield. This tried and tested concept of investing has, however, been fatally undermined by the recent crisis, which has left institutional investors in an unprecedented situation: the range of products on the financial markets lacks secure, conservative instruments which, at the same time, provide the certainty of a financial yield.

The current problematic character of the instrument of government bonds is well illustrated on the market within the framework of the increasingly integrated EU. The government bonds of the various member states represent a volatile instrument whose suitability for the portfolios of institutional investors is, in reality, conditional upon the state of the economy of each individual state. The current considerable distortion of the bond market caused by political support for the Euro has led to a tendency for the yield of the bonds issued by the various member states to decline, with relatively low volatility, which does not reflect the reality of the divergent economic performance of the member states. In this situation we see a clear paradox: the yield of the bonds issued by the various member states of the EU displays only a small range, while the already relatively high level of divergence between the economies of the member states has, if anything, increased further in the course of recent developments.

Moral hazard and negative selection

In this volatile environment with elements of moral hazard and negative selection, regulation is being further extended by politicians, which is controversial in two respects: on one hand, increased regulation requires that banks should create sufficient capital to absorb losses and recapitalisation, and that capital adequacy should, over a period of several years, be in excess of up to a third of the bank's capital. On the other hand, the central banks are implementing quantitative easing, which increases surplus liquidity in national economies and distorts the relationship between savings and investments, thus fundamentally disrupting the effectiveness of the allocation function of the financial markets. The question arises: from where in the future will banks create the resources required by their irreplaceable function as an institutional investor in the economy? In other words, how will they behave during the phase of accumulating their clients' temporarily disposable resources, and how will they motivate their clients to put those resources aside?

Despite individual problems, the Czech banking market is, on the whole, in good condition and is one of the most stable in the EU. On the other hand, the regulators' plans are raising concerns about the future effectiveness of the banking business.

Investment policy of insurance companies

Nevertheless, the national insurance market is affected significantly more by the current situation on the financial markets. Insurance companies are institutional investors in the economy mainly due to the way life insurance works. This segment, which creates temporarily disposable resources, has, in recent years, grown, but in the last year it has, however, suffered its first decline by seven tenths. In this respect, the decline in production in the first months of last year is particularly cautionary. One of the reasons for the reduced interest in life insurance is the loss of profitability of a product viewed as an instrument of investment. The technically zero yield of conservative instruments, the only ones in which life insurance companies can invest their clients' temporarily disposable resources, is leading the regulators to set upper limits for the technical interest rate of the products, guaranteeing a yield. In Germany the equivalent of the technical interest rate is set at 1.25 %, while the Czech National Bank , in its last adjustment, set the rate at an analogical level of 1.3% valid from July 1st. Insurance companies, however, have in their portfolios insurance policies going back years and even decades, in which they guaranteed their clients a yield of up to four percent, a level which can hardly be achieved in the current environment on the financial markets.

The investment policy of insurance companies has traditionally been regulated by the so-called setting of asset quotas, that is, the setting of minimum quotas for investing in safe assets and maximum quotas for risk assets. The problem with this is that the selection of safe assets and risk assets was set by the regulator in the period before the crisis and therefore reflects the conditions on the financial markets of that time. At the same time, conservative instruments, which now have a technically zero yield, do not ensure the insurance companies the resources they require to produce the yield which they guaranteed their clients with life insurance when they negotiated their insurance policies. The situation with investments in government bonds has already been described. At present, the search for more profitable instruments comes up against the maximum quotas set for risk assets.

The secondary use of a life insurance product as an investment instrument financing a client' s retirement is, therefore, becoming unattractive to clients, which is reflected in the reduced interest of clients and a loss of tempo in the life insurance business. More generally, the insurance sector has also been affected by increased costs arising from the implementation of the new Civil Code, the record loss of third-party insurance and the continued implementation of regulation which does not much take into account the specific characteristics of that branch of the economy, such as the introduction of so-called warranty schemes mandating the creation of sufficient reserves to cover the sudden collapse of a financial institution, although insurance companies are not, by virtue of the nature of their business, susceptible to sudden collapse. In addition, a fundamental change is on the way for insurance companies: Next year the controversial regulatory project Solvency II comes into full force. Among other things, the increased administrative burden it demands could prove to be financially fatal for smaller insurance companies in particular.

One of the aims of this contribution is to point out the symptomatic fact that the slight growth in the Czech economy and GDP in the last year has been stalled by the banking and insurance sector. The performance of those two branches declined year-on-year by more than ten percent, reducing Czech GDP by about half of one percent. An improvement can hardly be expected this year – rather the contrary.

Conclusion

The economic world is too complicated and, in many respects, both virtual and irrational. The problems are crystal-clear in the basic changes to the conditions for institutional investors in the economy. A logical alternative is to simplify or reduce the entire socio-political system. Complicated state interventions and rigid regulation will not turn the situation around. The question therefore arises: is there a possible alternative in the form of the reduction of the impact of the regulatory interventions of state and supranational institutions on the financial markets and institutional investors and a return to greater spontaneity on the markets?

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