


HIGHLIGHTS

OECD Business and Finance Outlook 2015

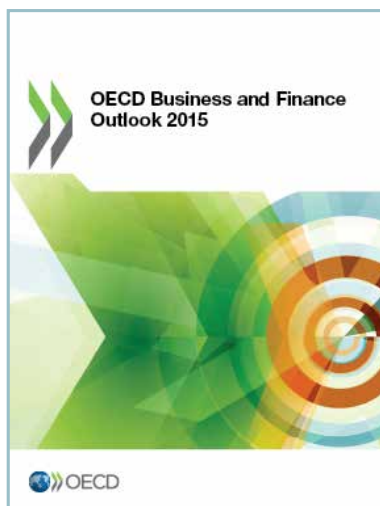




“Generating the resources needed to confront the challenge of ageing populations will require a greater reliance on solid company investment to underpin economic and productivity growth. Avoiding the bubbles and busts of recent decades will be essential.”

Angel Gurría, OECD Secretary-General

The greatest puzzle of today in business and finance



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The greatest puzzle today is that since the global crisis financial markets see so little risk, with asset prices rising everywhere in response to zero interest rates and quantitative easing, while companies that invest in the real economy appear to see so much more risk. What can be happening?

The puzzle is even more perplexing when we see policy makers lamenting the lack of investment in advanced countries at a time when the world economy shows all of the characteristics of excess capacity: low inflation and falling general price levels in some advanced countries for the first time since the gold standard and despite six years of the easiest global monetary policy stance in history.

Will financial markets be proved wrong so that asset prices will soon collapse? Or, alternatively, will business investment take off and carry growth and employment to more acceptable levels, validating the market optimism? The OECD Business and Finance Outlook presents a reconciliation of these apparent contradictions based on the bringing together of new evidence about what is happening in some 10,000 of the world's biggest listed companies as they participate in global value chains across 75 countries and which represent a third of world GDP. The salient points are these:

- There has been plenty of investment globally but, from an advanced country perspective, it has been happening in the wrong places as global value chains have broken down the links between policies conducted by governments inside their own borders and what their large global companies actually do. Short-termism too is apparent, where investors prefer companies that carry out more buybacks and dividends compared to those that embark on long-term investment strategies. Advanced country companies appear to prefer outsourcing investment risk to emerging market countries in global value chains when they can.
- From a developing country point of view financial repression and exchange rate targeting are legitimate development strategies. Investment is enormous (running at double the rate per unit of sales in general industrial companies compared to those of advanced countries), but it is not well based on market signals and efficient value creation strategies. Instead, it is fostered by cross-border controls, the heavy presence of state-owned banks that intermediate the “bottled-up” savings into investment, local content requirements and pervasive regulations and controls. Over-investment—characterised as a falling return on equity in relation to the high cost of equity that opens a negative value creation gap—is a feature of many emerging market companies which, at the same time, are borrowing too heavily.

- Concern about employment and growth in advanced countries has seen central banks vainly trying to stimulate investment at home: for six years they have kept close to zero interest rates and successive attempts at quantitative easing have been launched in the US, the UK, Japan and Europe. These actions are pushing up the value of risk assets in the search for yield, as pension funds and insurance companies face very real insolvency possibilities (with liabilities rising and maturing bonds being replaced by low-returning securities). The competition to buy high-yield bonds is seeing covenant protections falling, and less liquid alternative products hedged with derivatives are once more on the rise.
- Many of these new products are evolving in what has come to be known as the “shadow banking sector”: as banks themselves have become subject to greater regulatory controls financial innovation and structural changes in business models are once again adjusting to shake off the efforts of regulators. Broker-dealers intermediate between cash-rich money funds on the one hand, which need to borrow higher-risk securities to do better than a “zero” return, and cash-poor institutional investors on the other, that need cash to meet margin and collateral management calls that the new-generation higher-yield alternative products demand. Shadow banking is focused on the reuse of assets and collateral. With this comes a new set of risks for financial market policy makers to worry about: leverage, liquidity, maturity transformation, re-investment and other risks outside of traditional banking system.

The OECD Business and Finance Outlook provides evidence on some of these trends.

CHAPTER 1

Overview: Keeping promises in a low interest rate environment

This chapter presents an overview of the OECD Business and Finance Outlook 2015. It looks at the way in which companies, banks, shadow banking intermediaries and institutional investors are trying to deal with a climate of very low interest rates and structural change in the global economy. The “promises” of growth, employment and retirement income are seen to be at risk in the absence of policy actions.

The financial crisis that began in 2007 and peaked in September 2008 with the bankruptcy of Lehman Brothers and AIG’s bail-out has passed, but some legacies remain to be addressed. The international banking system has undergone major repairs, as comprehensive reforms to the regulatory framework for banks have been substantially agreed and are in the process of being phased in. Balance sheets have been recapitalised and probabilities of major bank defaults have fallen; bank interconnectedness has declined, even if it still remains high. Most advanced economies have recovered from the recession of 2009, but recoveries have often been weak and uneven despite low interest rates for several years. Discouragingly, the business sector continues to display a subdued appetite for capital expenditure. Inflation remains too low for comfort, employment performance continues to be lacklustre and public finances remain a concern, constraining policy options in many countries. The business and finance outlook remains complex and the manner in which banks, shadow banking intermediaries, institutional investors, and companies in both emerging and advanced economies are trying to deal with it presents new risks. These challenges can put at risk growth, the recovery of employment levels and the possibility of workers having access to a reasonable retirement income.

The limits of central bank liquidity policies

The global financial landscape today reflects legacies of the crisis. Large amounts of public money were spent supporting the financial system at the peak of the crisis, leaving a legacy of high public indebtedness. Policy interest rates were reduced to near-zero in most advanced economies to fight recession and these persist even today. Cash injections and other measures to increase the liquidity of the banking system (“quantitative easing”) were put into place partly to provide additional stimulus and avoid a “freeze” in money markets triggered by concerns of counterparty risk. One of the outcomes of these measures is a world awash with liquidity, flattening yield curves and a reduction of risk premia as reflected in financial asset prices. This strategy has encouraged large players in the financial markets to pursue a “search for yield” and to pay prices for assets in bond and equity markets that may not realistically reflect inherent risks.

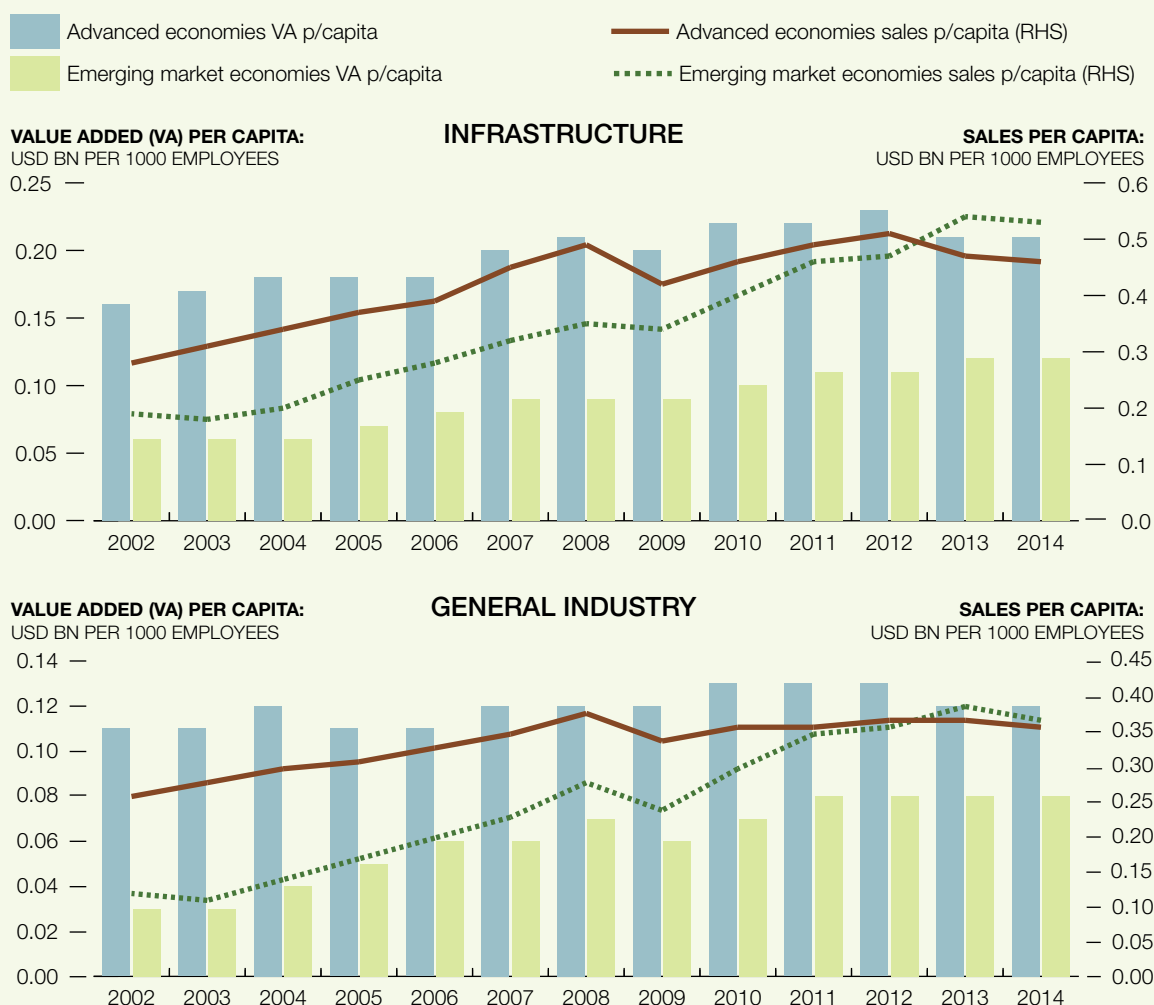
A risk puzzle

The resulting disconnect in risk arises when listed companies, who conduct a large proportion of the world’s capital formation, see considerable risk on the horizon while major players in financial markets seem completely unconcerned. This puzzling behaviour raises the spectre of a potential new crisis and the need to take appropriate measures to anticipate repercussions when one or the other of these views eventually proves to be wrong. The needed response must be built around three structural realities in the world economy:

- The centre of gravity of the global economy is shifting from the advanced economies around the North Atlantic to the Asia-Pacific region, in particular to a group of highly competitive and mostly-emerging economies. Financial claims on non-financial businesses in advanced economies operating in open competitive markets are thus underpinned by their ability to adapt global value chains to this reality.
- Populations in advanced economies, especially in Japan and in much of southern and central Europe, are ageing. They will be increasingly dependent on commitments from pension funds and insurance companies as well as on returns from their own savings managed as collective products by investment companies. Pension plans and retirement products such as annuities and mutual funds must meet customer expectations about returns, while being designed to take account of longevity risk in an environment of low interest rates.
- Notwithstanding large-scale financial reform designed to insulate taxpayers from the need to cover losses, local problems can easily become systemic in an interconnected system. This implicitly guarantees much more of the claims in the system than what is explicitly insured, creating potentially adverse incentives.

How can the system deliver on these promises? A number of priorities stand out.

Figure 1. Productivity of sales versus value added in advanced and emerging country infrastructure and general industrial companies



Note: See page 20.

Source: Bloomberg, OECD calculations.

The global value chains that facilitate the shift in the centre of gravity of world economic activity towards emerging markets are not serving economic development in the manner that might be expected.

Sales-per-employee, shown by the lines in Figure 1, illustrate an astounding “catch-up” of emerging countries over the past decade. However, when company “value added” per employee is calculated (shown in the bars), there is much less sign of any emerging market catch-up to advanced country productivity levels, in either infrastructure or general industrial companies.

Worse still, the “value added” productivity growth apparent in the rising columns prior to the crisis has not continued in subsequent years. This is no way in which to foster promises for ageing baby boomers, nor for the stable growth of employment for younger generations. The international financial and production systems will have to be reformed towards greater competition and openness if the world economy is to be put onto a more stable path.

Global value chains and investment

The global environment in which financial markets operate must include effective macroeconomic adjustment mechanisms. The issue is not just current account imbalances. The world has benefitted from the globalisation encouraged by open international trade and investment regimes. Business sectors in both advanced and emerging market economies have developed global value Chains (GVCs) that transfer technology and distribute production where it can be carried out most effectively. This behaviour has contributed to productivity gains in emerging markets, especially in Asia, prior to the crisis. Subsequently, however, while sales per worker (which includes foreign value added) have continued to rise, the trend does not appear to have been matched by growth in domestic value added.

This “outsourcing” has also led to important shifts of production by multinational enterprises (MNEs) mostly away from advanced economies, which has resulted in weaker capital formation in these countries. value added per employee has not been rising in listed companies of advanced economies since the crisis. Transferring investment in this way may improve operational efficiency, but this should not be confused with investment in R&D and genuine productivity growth.

The tougher post-crisis environment is also leading to considerable divestment of international operations by MNEs. This suggests that restructuring and retrenchment continues to be a focus. adjustment mechanisms need to work better to encourage compensating investment in other activities including R&D and social infrastructure, and to generate better employment performance. Unless this is done, “secular stagnation” concerns will continue, protectionist threats to the open trade and financial system can be expected, and new doubts will emerge that resources for ageing populations promised by institutional investors like pension funds and insurance companies will be sufficient when called upon.

The international financial system

The currencies of most advanced economies float reasonably cleanly, facilitating adjustment, and for most of the post-Bretton woods period this arrangement has worked well; but, the weight of emerging economies has risen to around half the world economy and these economies often manage their exchange rates heavily against the us dollar. Fiscal and monetary authorities in advanced economies may try to compensate while market pressures drive yields down. This encourages the creation of potentially higher-yield but riskier and potentially illiquid assets to satisfy the demand of longer-term investors in pursuit of returns to meet their long-term promises. At the same time, the lack of international competitiveness due to exchange rate overvaluation discourages new investment.

Declining company returns

International adjustment by itself is not enough. The returns on equity of listed companies have declined in much of the world, particularly in Europe and in emerging markets. These returns are now often below capital costs and even below the (low) cost of debt in emerging economies. This is a sign of potential over-investment, lack of competition and persisting inefficiencies. If performance is to improve, real returns on capital that will be reflected in returns on equity must be raised to make capital formation more attractive. in emerging markets this requires reducing over-investment and inefficiency and finding a better balance between consumption and investment, especially where financial repression and state-owned enterprises play a large role (the latter account for 45% of the listed sector in EMEs). There is a need to move away from replicative investment in manufacturing towards a greater focus on social infrastructure, the quality of labour and domestic demand linkages. in the advanced economies, it requires supplementing better international adjustment mechanisms with pro-competition policies, involving effective measures at the micro-economic level, that encourage innovation and investment.

Banks and shadow banking

As deleveraging ceases to be a priority, the supply of bank credit should improve and begin to ease financing constraints facing many businesses, especially small and medium-sized enterprises. It is important that new supervisory and regulatory regimes preserve the improvements that have been introduced to date, and ensure that past excesses are not repeated. Notwithstanding these reforms and improvements, banks still remain interconnected and vulnerable to rising exposures to each other, especially through large derivative positions and the collateralisation of borrowing, in the event that prices in financial markets suddenly and unexpectedly change. The best way to deal with this is clear separation of insured deposit banking from prime broking, custody and collateral services and derivatives trading so that losses in one segment do not absorb the capital of other lines of business. However, to the extent that the reforms associated with Volcker, Vickers and Barnier finally depart from this goal, it is all the more important to ensure strong bank capital bases which can act as shock-absorbers and contain local losses without damaging counterparties.

The strengthened regulatory framework that now applies to banks has increased their need for cash and high quality liquid assets, mainly government paper, and raised the costs of using repurchase agreements and derivatives. This has encouraged them to shift some activities to processes often referred to as shadow banking (alternatively, “market-based financing”). These do not primarily deal directly with non-financial lenders or borrowers but intermediate mainly between other non-bank financial institutions. These other institutions are generally either cash-short (such as pension funds and insurance companies), or cash-long (such as money market funds). In the low interest rate environment all of these funds need to improve their yields on investments. This incentivises them to reuse assets through securities lending and the buying of alternative assets with complex derivatives aspects. But, to engage in these activities also draws them into the need for cash for margin and collateral management according to the new regulatory rules. shadow banking involves the main broker dealers, custody banks, lending agents and centralised clearing counterparties (CCPs) intermediating the needs of cash-poor institutional investors looking to reuse assets and cash-rich non-banks that are searching for greater exposure to securities given the low interest rates on cash. Shadow bank activities include securities borrowing and lending, trading and clearing of derivatives, custody services and collateral management.

While shifting these activities away from the banks moves certain risks it does not eliminate them. Rather it transfers them, at least partly, to the shadow banking world. these risks boil down to various types of market and credit risks, including counterparty risk, reinvestment risk, re-hypothecation risk, maturity transformation risk and clearing risk. It is precisely because of these risks that counterparties must provide collateral to insure exposed positions. Securities being lent to improve yields must be collateralised, and cash provided for margin payments are frequently reused (“re-hypothecated”). This allows a relatively small amount of cash to collateralise a large set of positions so long as these are well-hedged or balanced. But, in the event of a surprise in market developments, large net cash demands can materialise quickly which would put stress on the entire system allowing little time to work out problems.

So long as the system remains inter-connected, and especially if shadow bank activities are not separated from traditional deposit-taking and bank lending activities, the financial system remains exposed to unforeseen shocks. Some ways to minimise these risks include improving transparency, especially as regards data on derivatives and collateral; establishing minimum holdings of cash to address maturity transformation risks; limiting the reuse of cash in repurchase markets; establishing minimum capital requirements for CCPs; and providing last resort facilities to broker-dealers.

Corporate bonds

Low interest rates encourage borrowing in general, and the demand for higher yield products has encouraged companies in more speculative sectors and in emerging markets to issue higher-yield debt. Institutional investors in search of yield compete for this debt, which is often referenced in alternative products and used in securities lending and exchange-traded funds. The competition for yield has seen a dramatic fall in covenant protections, which reduces the liquidity of these bonds. In a period of stress, as might arise in a future normalisation of monetary policy, the illiquidity features may exacerbate price volatility and put pressure on collateral management in the shadow banking sector.

Dealing with longevity risk and pension and annuity “promises”

The institutional investors who mobilise a large part of modern economies' savings and try to allocate these to uses which will pay the highest returns while managing risks face tremendous challenges. Pension funds and life insurance companies, which are the largest sectors, not only have to find ways to generate sufficient returns to keep their commitments to savers, but must also manage the longevity risk associated with defined-benefit pensions and annuities arising from uncertain mortality. Defined contribution pension plans and other savings vehicles managed by insurance and investment companies may protect these financial institutions from this risk, but only by shifting it to individuals who are poorly placed to manage it.

How do institutional investors do this in the current and prospective low interest rate environment, in which maturing fixed income assets can only be refinanced on less remunerative terms, or with alternative investments and high-yield corporate bonds that promise high returns but are generally illiquid and seemingly over-priced? This question points to the fundamental importance of strengthening the economic environment in ways that raise the real return on capital. This can ensure that new capital formation, especially in advanced economies is attractive and eventually delivers the returns that allow the institutions' promises to be met. Failing that, these institutions may face a challenge in delivering their commitments to retired savers dependent on them.

The rising share of assets invested in high-risk or potentially illiquid assets other than cash and marketable securities, such as leveraged hedge funds, high-yield corporate bonds, private equity and commodities, warrants vigilance by regulators and policy makers. There is a very real risk that the current trend for companies to return cash to shareholders via dividends and buybacks, as a way to boost short-term returns, will not be re-invested in more productive companies but instead into more leverage in alternative assets to which pension funds, in particular, are beginning to allocate more capital.

Small businesses financing

With banks adjusting to new regulatory arrangements intended to make activities other than traditional lending more costly in order to minimise systemic risks to the monetary system, external financing for investment will have to come increasingly from non-bank sources. For many large companies directly accessing the capital markets has always been the most efficient way to proceed and others have been gravitating there as universal banks become less responsive to their demands. For small and medium-sized enterprises the relationships they can establish with banks, and the collateral where they can offer it, make banks the best sources for most external funding for them, once the strains of deleveraging have passed. But capital markets are better placed to accept the risks inherent in providing long-term funding for dynamic and innovative small businesses in their start-up and early expansion phases. They are also better positioned to provide exit opportunities for angel investors and venture capital providers whose expertise is precisely with start-ups and who want to realise gains (rather than hold positions over long periods as the pension and insurance companies do). Thus, strengthening capital markets outside the banking system is a priority.

Capital market infrastructure

Strengthening capital markets involves more than bringing sources and users of funds together. it also requires building a strong institutional infrastructure which can handle the flows of money and information with transparency and integrity. The day-to-day operation of the markets must encourage price discovery that creates incentives to match providers and users of funds in ways that capital will be used most productively.

At the same time, risks must be borne by those best placed to bear them. The institutions and people that make markets function on a day-to-day basis, from the exchanges and the dealers to the accountants and the analysts, have had to adapt for many years to major changes ranging from the shift of the world's economic centre of gravity to the Asia-Pacific region to the move of financial activity online, as digitalisation has advanced. They have also had to cope with sudden shocks, from large oil price changes to recurrent financial crises. The regulatory environment has been changing in response to these forces. Several issues relating to incentives operating on key people who make illiquid markets function, the fragmentation of markets, high-frequency trading, complexity of investment chains and their implications have risen to the forefront. These may not have such high visibility as the other issues discussed above, but it is essential that policy makers do not lose sight of their importance for the financial sector.

CHAPTER 2

Corporate investment and the stagnation puzzle

Following the easy monetary policies brought on by the crisis, financial markets have rallied strongly while companies that undertake capital spending do not appear to see the same value creation opportunities. Despite historically low interest rates, economic growth is stagnating in many regions due in part to the lack of investment. This is true of companies in the general industry, infrastructure and clean energy sectors. This chapter explores this puzzle from the point of view of bottom-up data of 10 000 of the world's largest companies listed in the Bloomberg World Equity Index for both advanced and emerging countries, which enables capital spending and matching financial data to be used over the period 2002-2014.

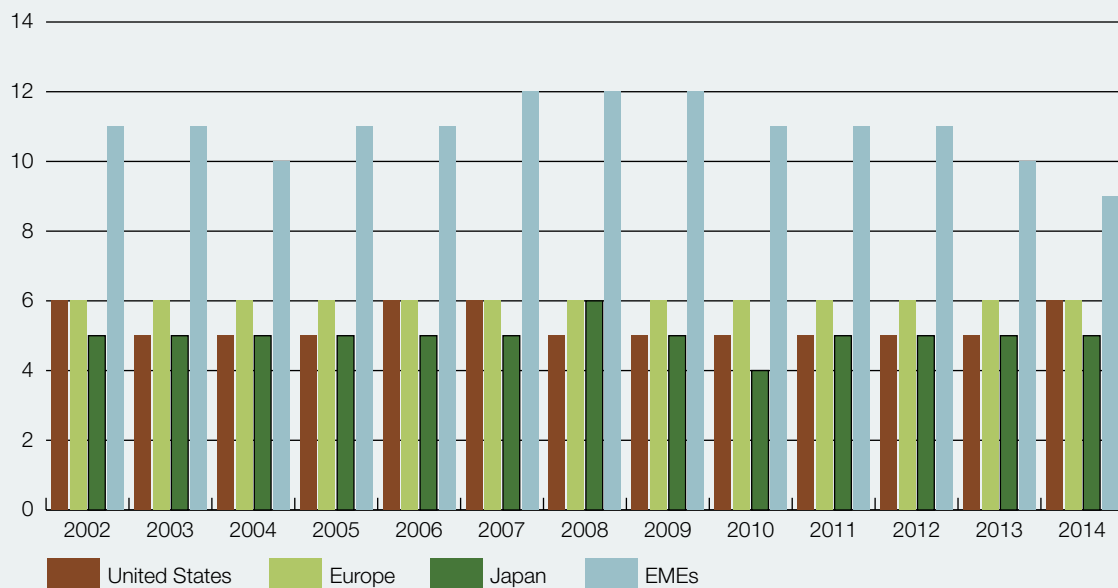
Main findings

- Assuming unchanged policies, the outlook is for lacklustre company investment, with general industry stabilising and infrastructure growing modestly, but certainly not sufficient to be a meaningful driver of world economic growth.
- Investment and innovation in the larger general industrial sector is essential, both for generating bankable returns for the infrastructure sector and for productivity growth.
- The perception of stagnating investment in advanced countries is due in part to the activities of multinational enterprises in global supply chains: the centre of gravity of world activity has shifted more towards emerging market economies (EMEs).
- Much large investment by multinational enterprises is associated with the transfer of intellectual property for participation in global supply chains. This has resulted in “catch-up” of sales-per-employee in EME companies versus advanced countries (and profits for the latter) but value added per employee is not catching up. By focusing more on operating efficiency and tax strategy, companies appear to have focused less on investment in R&D and innovation that is necessary to drive long-term productivity growth.
- Declining returns on equity and profit margin compression are evident in large companies, particularly in EMEs and Europe, due to this poor productivity growth and to over-investment in the general industrial sector of EMEs: their returns on equity have declined below the cost of equity and in some case below the low cost of debt (measures of over-investment).
- Over-investment and inefficiency appear to be more pronounced where financial repression policies are used to bottle up saving for investment in development strategies, and where tax incentives and state-owned enterprises play a disproportionate role. Evidence supports the idea that state-owned enterprises in EMEs do not share a level playing field (in commercial terms) with private industry in the infrastructure sector, compared with the more equal environment in advanced countries. Tax is shown to have a big impact on the location of investment.
- A theoretical global portfolio based on selling the highest quartile of heavier capital-spending firms to buy the bottom quartile that favours dividends and buybacks generates very strong positive return performance. This bias against investing companies may be due to increased uncertainty and the role of activist shareholders: it makes chief executives hesitate to invest for fear of a stock market attack.
- Operating cash flow is not sufficient in EMEs to cover capital expenditure, dividends and buybacks and the desired net acquisition of assets, resulting in borrowing to fund the gap. the opposite is true for advanced countries, particularly the united states where investment could be doubled at the expense of buybacks without borrowing or issuing any new equity.
- The combination of over-investment, inefficiencies and excessive borrowing in some parts of the global value chain while others invest less is not a sound recipe for productivity growth and the long-term value creation needed for the future support of ageing populations, and it also raises the risk of a new financial pressures centred on EME company debt.

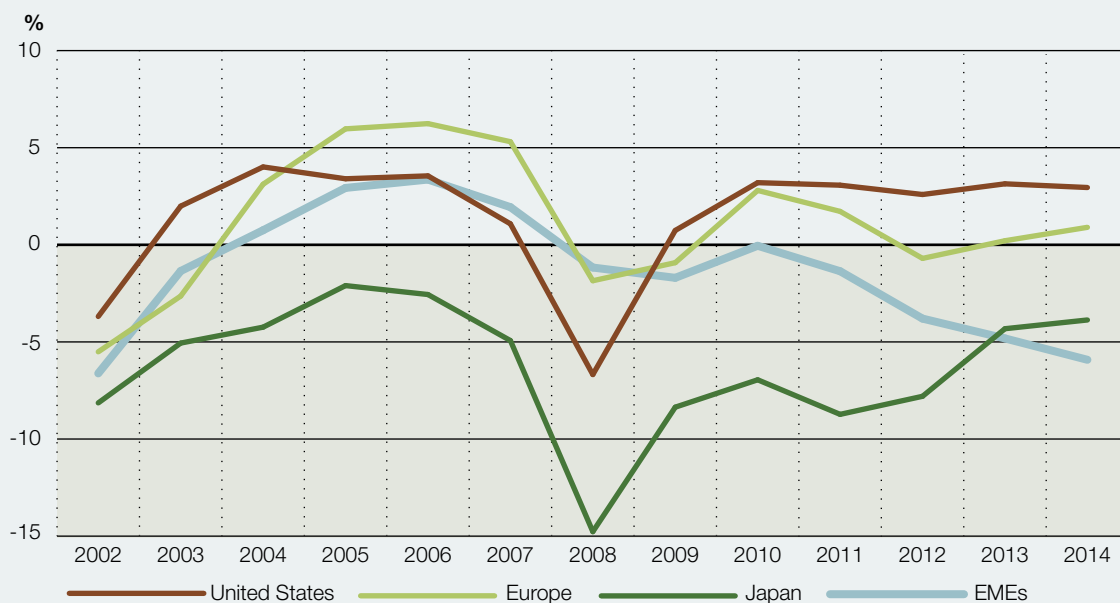
Figure 2. Thinking about over-investment

Capital spending per unit of sales in general industry

% NET SALES



Emerging markets' ROEs falling versus the cost of equity in general industry – Opening a value creation gap



Note: See page 20.

Source: Bloomberg, OECD calculations. Based on a Bloomberg index of 10 000 companies in 75 countries.

In Figure 2, capital spending for general industrial companies (not infrastructure) is shown for four regions. Emerging markets, which are more than half of the world economy are investing at double the pace (per unit of sales) of advanced country groups. In the bottom panel, the corresponding ROE minus the cost of equity is shown. For emerging markets, this moved below zero in 2008 and the “value creation gap” has continued to deteriorate since.

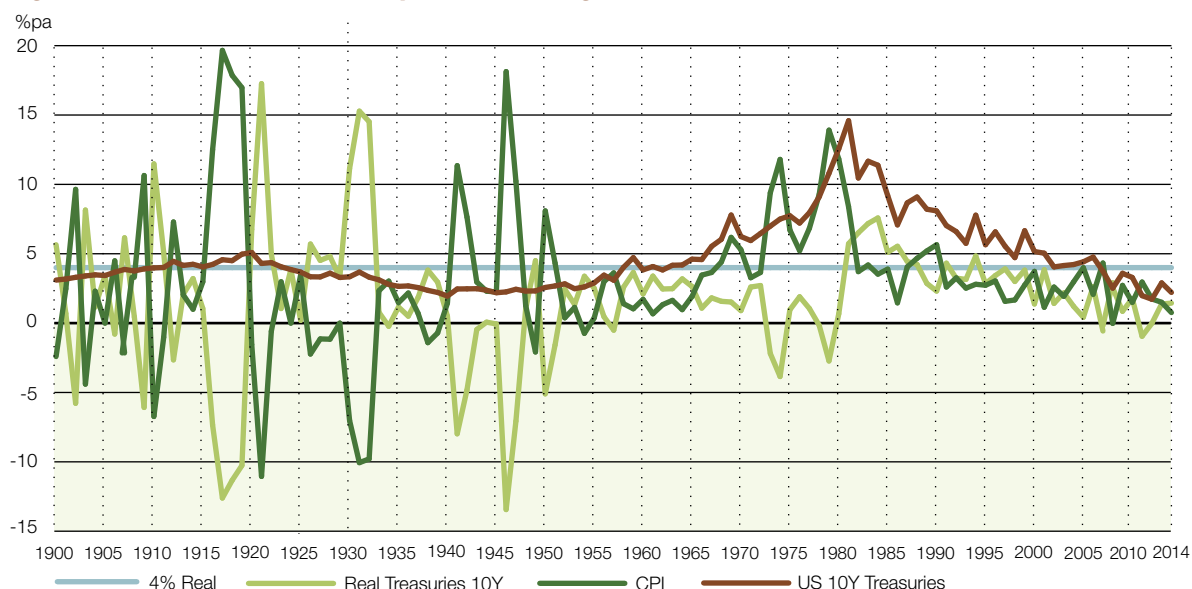
CHAPTER 3

Shifting risks and the search for yield in financial markets

Policies and regulatory responses to crises tend to roll financial excesses into other sectors or regions. This chapter argues that the response to the 2008 crisis has rolled the risk into the shadow banking and corporate bond sectors. Shadow banks intermediate credit between cash-rich and cash-poor investors in their bid to reuse securities and to gain access directly or synthetically to higher-yield and lower-risk alternative products in a world of low interest rates and rising longevity risk. At the root of the problem are a number of implicit promises that have been made to investors that are unlikely to be met in the absence of structural change and better regulation.

- Main findings**
- The global financial system is evolving in a way that means certain “promises” about long-term value creation, pension replacement rates and the safety of the financial system may not in fact be met.
 - The rising size of the emerging market “dollar bloc” and its integration into global supply chains is contributing to low inflation and low interest rates. There are signs that restrictions on cross-border flows are rising again. Over-investment and inefficiencies in parts of the global value chains are at the same time undermining the fundamental longer-term value in equities and bonds.
 - Over the next five years pension funds are expected to grow 26% from an estimated USD 28.4 trillion in 2014 to USD 35.8 trillion in 2019; insurance companies 33% from an estimated USD 28.2 trillion in 2014 to USD 37.7 trillion in 2019; and mutual funds 38% from an estimated USD 33.4 trillion in 2014 to USD 46.1 trillion in 2019. These funds are naturally cash-short and securities-long—but the need for new products that improve yields has incentivised them to try to “unlock” liquidity to obtain cash to manage margins and collateral needs associated with complex products and to reuse their securities by lending them.
 - This occurs at a time when banks are being more constrained via regulation and higher costs are associated with counterparty transactions. The balance of financial system risk is shifting away from regular insured deposit banking towards shadow banking (the intermediation of credit for cash poor institutional investors via broker dealers and custody banks).
 - At the same time, company borrowing is shifting away from banks towards non-bank bond issuance in the capital markets. The competition amongst lenders is so strong in the high-yield segment that less covenant protection is being traded for higher yields. This is a form of liquidity illusion (more yield now while illiquidity issues will be apparent only later).
 - The competition amongst institutional investors for yield products is so strong that the shadow banking system is also facilitating new complex products that promise: higher yield with lower volatility; or synthetic exposure to underlying illiquid securities but with daily liquidity—another form of liquidity illusion.

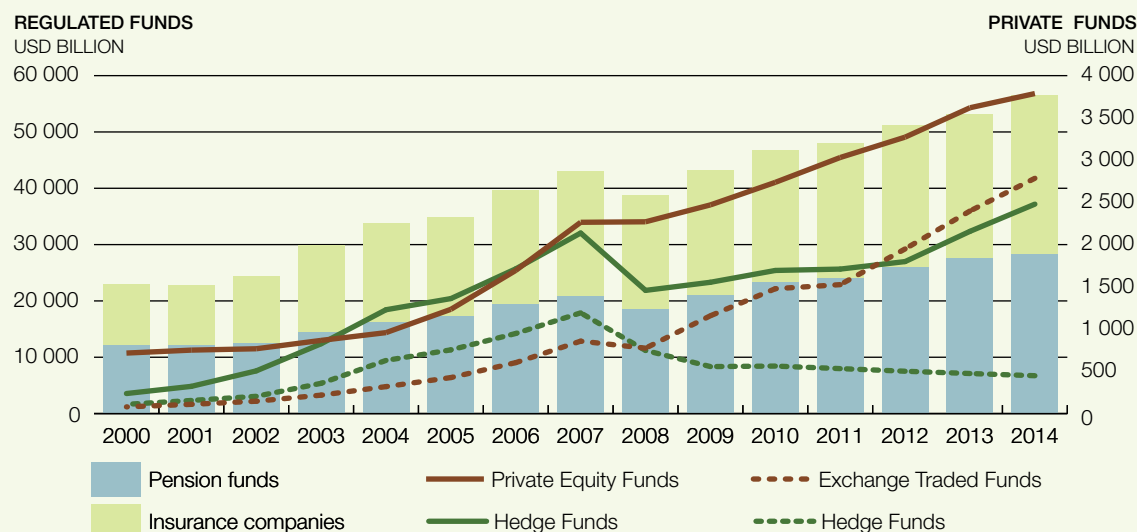
Figure 3. Low interest rates could persist for a long time



Note: See page 20.

Source: Datastream, Shiller, OECD calculations.

Figure 4. Private funds versus regulated funds

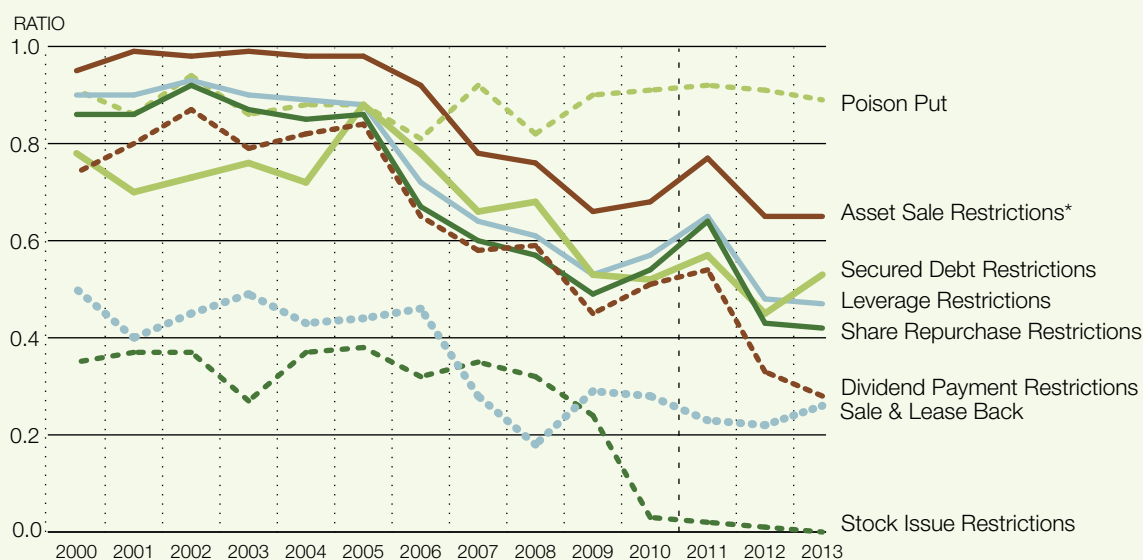


Note: See page 20.

Source: BarclayHedge, 2014 Preqin Global Private Equity Report, ETFGImonthly newsletter (February 2015), OECD calculations.

Figure 4 shows the pension and insurance company assets on the right scale versus some of the alternative assets on the left scale from Table 3.2 in the Outlook. One strategy since well before the crisis has been for asset owners to move towards passive (index) funds in their long-only holdings (and away from higher-fee funds that promise but for the most part don't deliver "alpha" versus a benchmarks).

Figure 5. Covenant Protection Index and selected covenant frequency



Note: See page 20.

Source: Çelik et al., 2015

Figure 5 shows some of the categories used in the index for high-yield bonds. The reasons behind this appear to be:

- Competition amongst lenders in a low interest rate environment.
- A form of short-termism whereby performance pressure leads to investment manager incentives to sacrifice covenant protection for higher yields because the returns are immediately apparent, whereas 'covenant-lite risk' will manifest itself much later (Choi and Triantis, 2012).
- The proliferation of new products that involve securities lending may be facilitating these trends as risk is being continually shifted around and/or is hedged.
- Activist hedge fund actions prior to the crisis (on the basis of the late filing covenants) have led issuers to rephrase provisions in order to avoid such disputes in the future.

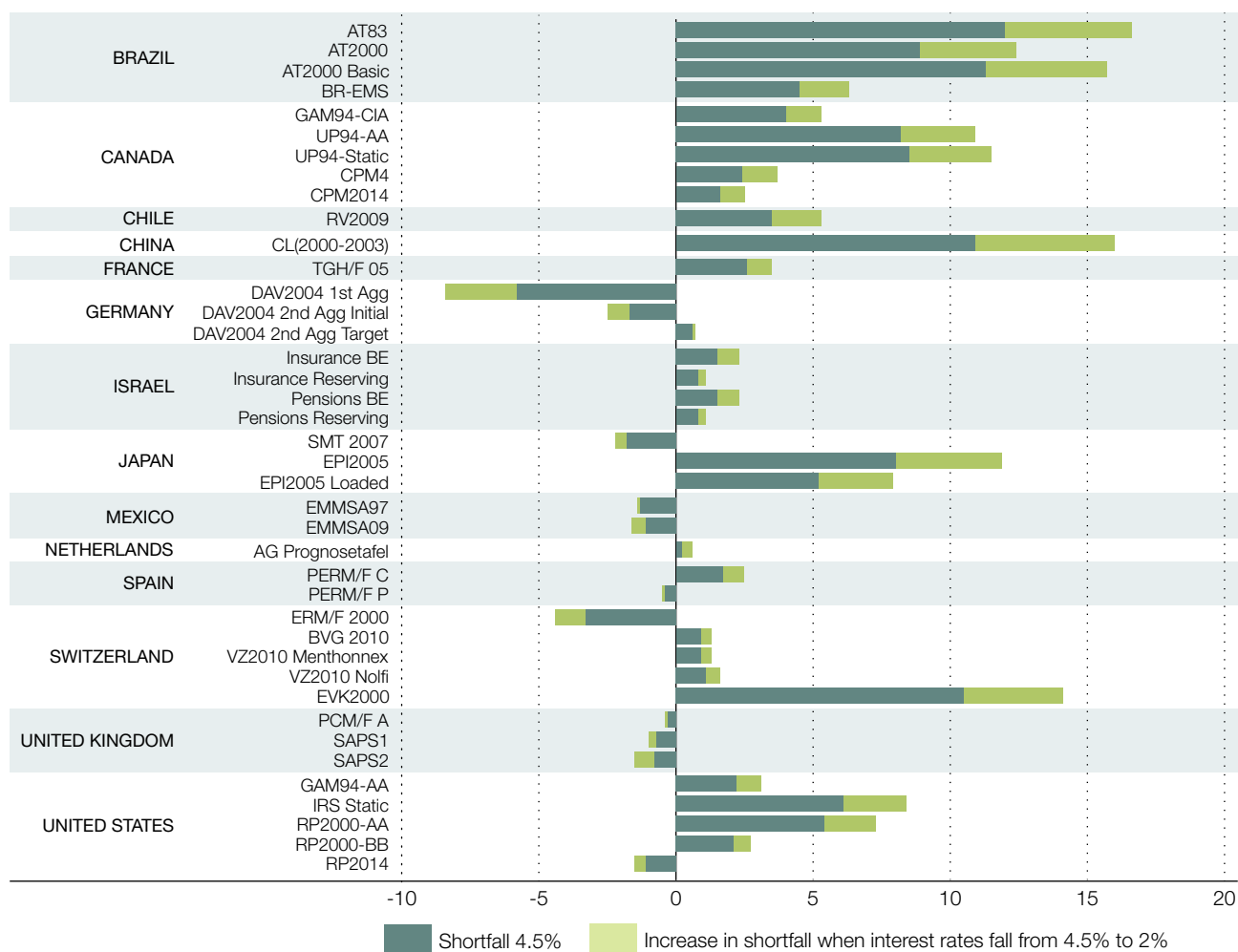
"Covenant-lite" bonds are less liquid and would require larger price movements in order to find buyers in a stressed environment.

CHAPTER 4

Can pension funds and life insurance companies keep their promises?

This chapter examines the potential impact of an environment of protracted low interest rates on pension systems and life insurance companies. It describes the mechanisms through which prolonged low interest rates can affect the solvency position of these institutions and uses available data to assess potential impacts. The outlook for the solvency position of pension funds and life insurance companies is of concern. Insofar as their promises are linked to evolving parameters or can be adjusted to the new environment of low interest rates, low inflation and low growth, these institutions may be able to weather the situation. However, there is a very serious concern for the financial outlook should these institutions become heavily involved in an excessive “search for yield” in order to fulfil any fixed guarantee promises they may have made when interest rates were higher. Regulators and policy makers should remain vigilant.

Figure 6. Drop in interest rate increases exposure to mortality risk tables across countries
Average shortfall females, age 65



Note: See page 20.

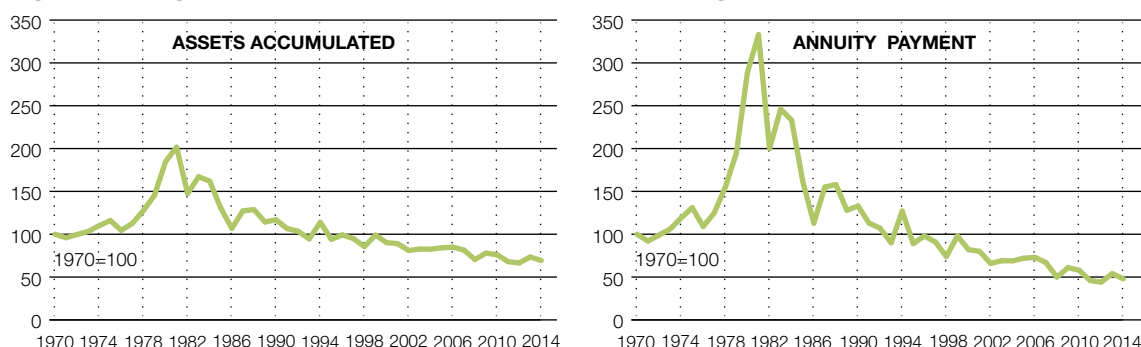
Source: OECD calculations using OECD work on Mortality Assumptions and Longevity Risk.

The exposure to longevity risk coming from different mortality assumptions used by pension funds and annuity providers is exacerbated in an environment of low interest rates. Figure 6 shows the sensitivity to interest rates of the exposure to longevity risk based on the different mortality assumptions used in different countries for pension funds and annuity providers. The red bar shows the increase in this exposure associated with a fall in interest rates from 4.5% nominal assumed in the original calculation of the OECD work to 2%. The trends are the same for males.

Main findings

- An environment of prolonged low interest rates linked to ongoing low growth and falling inflation rates poses serious challenges to insurance and pension systems and in particular to defined benefit pension funds and life insurance companies offering long-term financial promises.
- The outlook depends foremost on the nature of the promises made by pension funds and life insurance companies and the potential for their adjustment or reversibility. The adverse effect of low interest rates is higher where the liabilities of these institutions consist of a fixed investment return or fixed benefit or pay-out promises.
- For pension funds and life insurance companies in particular, the outlook is troubling as their solvency positions will deteriorate unless they have actively adopted risk management strategies. Given problems being experienced by these institutions, some countries are already adjusting their regulatory framework on an exceptional basis, or otherwise maintaining measures adopted during the financial crisis to relax regulation while increasing monitoring.
- Potential solutions include increasing the duration of assets to be in line with that of liabilities, renegotiating promises and adjusting existing contracts, increasing contributions (for DB pension plans), and regulatory forbearance.
- The main concern is whether pension funds and life insurance companies have, or might, become involved in an excessive “search for yield” in an attempt to match the level of returns promised earlier to beneficiaries or policyholders when financial markets were delivering higher returns. This might heighten insolvency risks.

Figure 7. Changes in retirement income as interest rates change

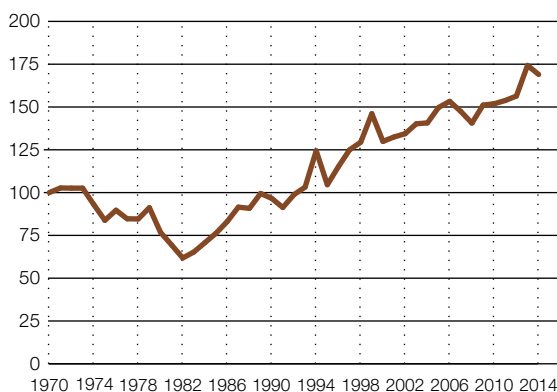


Note: See page 20.

Source: OECD calculations

Figure 7 shows the hypothetical impact of long-term interest rates trending downwards on assets accumulated and annuity payments, using as discount rates the actual United States long-term government yield. The decline in rates has a direct effect on the retirement savings of DC plan members through lower assets accumulated and lower pension income those assets can provide.

Figure 8. Evolution of the present value of an hypothetical fixed cash flow promise payable over 20 years when interest rates fall



Note: See page 20.

Source: OECD Secretariat calculations.

The impact of low interest rates will be highest when the promise is fixed in nature. As interest rates fall, resulting in a decline in the discount rate applied to calculate the present value of future pay-outs, the present value of a fixed promise or cash flow becomes bigger in the future. Figure 8 shows the evolution over the period 1970-2014 of the present value of a cash flow of 100 currency units payable for 20 years to approximate life expectancy at 65, using as discount rates the actual United States long-term government yield (Figure 4.1). The fall in interest rates over the period from 6.24% to 2.21% results in an increase of 69% in the present value of the liabilities.

CHAPTER 5

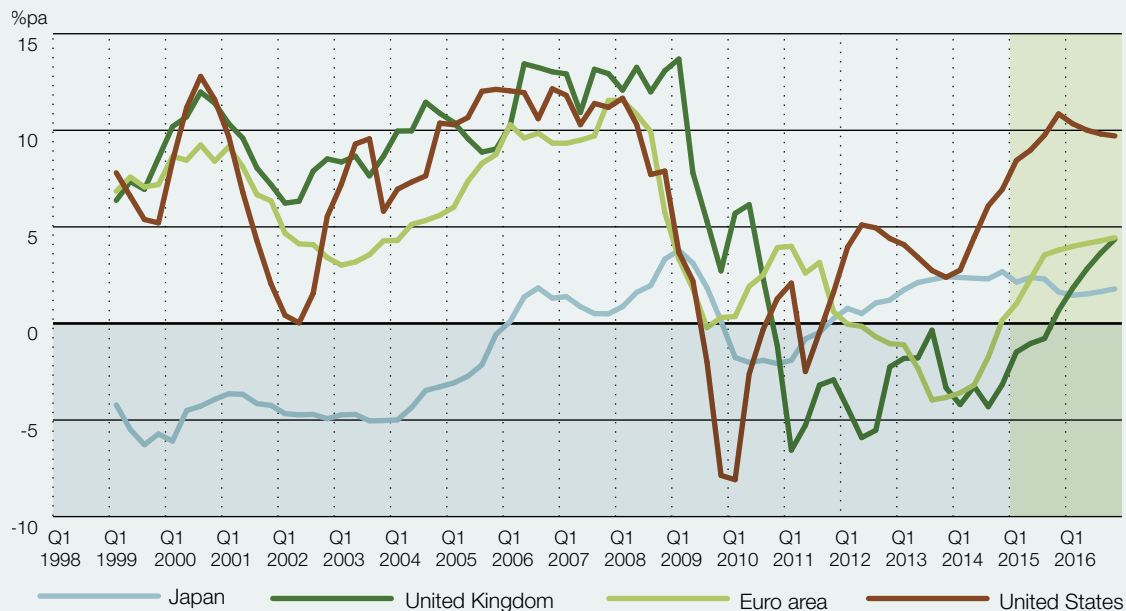
Bank and capital market financing of small and medium-sized enterprises

Small and medium-sized enterprises (SMEs) play a significant role in their economies as key generators of employment and income, and as drivers of innovation and growth. They are essential for the economic recovery from the current economic and financial crisis, which has reduced bank lending and affected SMEs in particular because credit sources tend to dry up more rapidly for small firms than for large companies during economic downturns. This chapter identifies bank lending gaps that have opened up since the crisis and that are especially pertinent outside the United States. Therefore, a two-pronged approach to fostering SME financing (in as far as it is a supply problem) is proposed: first, restoring banks' health to improve bank lending; and second, supporting the development of a broad range of non-bank financing for SMEs in debt and equity markets, the latter being especially well-suited for small dynamic, innovation-oriented SMEs. The chapter concludes that, owing to their diversity, the financing of SMEs remains complex and requires a variety of instruments and approaches. Policy makers can help by providing regulatory support and assist in the improvement of data transparency, standardisation, and raising awareness about available financing options.

- Main findings**
- The crisis has had a negative effect on bank lending. Current bank lending is still below its long-term trend in major OECD economies and this bank lending gap is estimated to be especially pertinent outside the United States. Small and medium-sized enterprises (SMEs) have been more vulnerable and affected than larger corporations.
 - A two-pronged approach to foster SME finance – in so far as it is a supply problem – is needed: restoring banks' health to improve bank lending, and supporting the development of a broad range of non-bank financing for SMEs, in particular in debt and equity markets, with the latter being especially well-suited for small dynamic, innovation-oriented SMEs.
 - SMEs access to bank finance during the crisis was especially difficult, against a background of a sharp decline in bank profitability and an erosion of bank capital that negatively affected lending. restoring the health of banks' balance sheets and undertaking structural bank reforms can help to restart bank lending to the real economy.
 - Among non-bank debt financing instruments, securitisation, private placements and bonds can play an important role. Securitisation was tarnished by the crisis and has experienced decline, but could help to fill the lending gap if placed on the right footing. For mid-sized companies, bond issuance and private placements provide useful alternatives.
 - Equity finance takes place across a wide spectrum of instruments, in line with the various stages in a typical life-cycle of an SME. There are potential benefits for policy support targeting the development of SME equity financing platforms and instruments. Fostering SME equity financing, which would support riskier, but more dynamic and innovative SMEs, can be especially helpful in facilitating growth of the real economy.

Figure 9. Lending in major economies outside the United States is projected to pick up less strongly

Bank lending to the non-financial private sectors year-on-year percentage changes, projections until Q4 2016-



Note: See page 20.

Source: OECD calculations, Thomson Reuters Datastream.

Bank lending projections for the United States, euro area, the United Kingdom and Japan until Q4 2016 are shown in Figure 9, based on OECD economic projections for GDP and interest rates, but with unchanged regulatory rules. United States lending picked up earlier than elsewhere, and is unique amongst the economies shown and beginning to approach lending growth more reminiscent of the pre-crisis period. There are two basic reasons for this: (i) the more pre-emptive policies followed during and after the crisis; and (ii) the fact that the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac absorbed a large amount of problematic mortgage loans that were pushed off banks' balance sheets. Consequently, with nominal GDP set to grow by 4% in 2015 and 2016, lending is projected to accelerate further and is set to peak at over 10% in late 2015 before beginning to slow somewhat through 2016.

CHAPTER 6

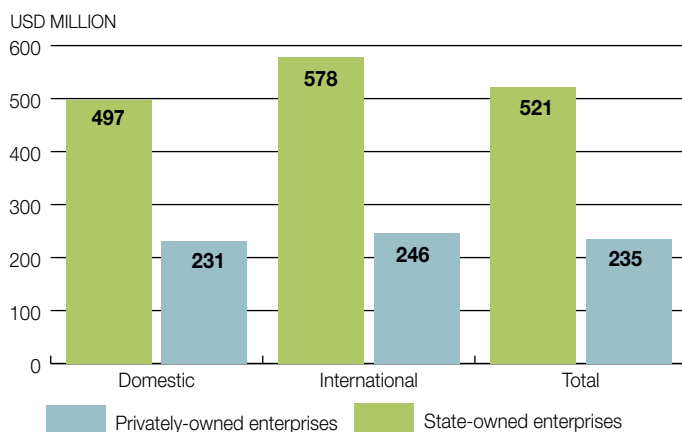
Multinational enterprises and the shifting global business landscape

This chapter examines the topic of cross-border financial flows involving multinational enterprises using data on international mergers and acquisitions and foreign direct investment. It begins with a survey of recent trends from a global and regional perspective. It then considers three factors that are shaping the outlook going forward. These are: broader economic trends, the growing involvement of governments in the governance of the global economy, and the sustainability of MNE investment from emerging market economies.

Main findings

- The outlook for international investment by multinational enterprises (MNEs) is mixed.
- While the current gap between merger and acquisition (M&A) transactions and stock market valuations hints at the possibility of a significant increase of cross-border M&A transactions over the next few years, weakness in the emerging market economies and a sharp rise in international business divestment are factors pushing in the opposite direction.
- Although governments have resisted protectionist pressures and remain generally open to cross-border investment, various forms of government involvement in the governance of the global marketplace, such as support schemes for green energy and the review of cross-border mergers and acquisitions, would seem to be holding MNE investment back in some sectors and markets.
- Cross-border investment has shifted gears from a pre-financial crisis growth trajectory to a post-crisis restructuring trajectory, with record levels of divestments of MNE assets being sold back into domestic ownership.
- An important counter-cyclical source of cross-border investment during the crisis came from emerging market economies. This trend now seems to have changed course, with emerging market shares of inward and outward cross-border M&A declining in recent years. Outward cross-border M&A from the emerging market economies, China in particular, may be unsustainable.

Figure 10. Average deal sizes of state-owned and privately-owned enterprises, 1996-2013



Note: See page 20.

Source: Dealogic M&A Analytics database, OECD calculations.

State-owned enterprises (SOEs) have become important players in the global marketplace, in particular during the global financial crisis that started in 2008, when SOEs played an important counter-cyclical role. However, concerns have also been raised about possibly unfair advantages that SOEs enjoy in global markets by virtue of their links to governments.

Among the most commonly cited among these is access to preferential financing for their international investments. Although it is difficult to prove empirically that SOEs do enjoy such advantages, a comparison of how SOEs and privately-owned enterprises (POEs) structure their cross-border M&A deals does point in this direction. Figure 10 shows that the average international deal size of SOEs is more than double that of POEs.

CHAPTER 7

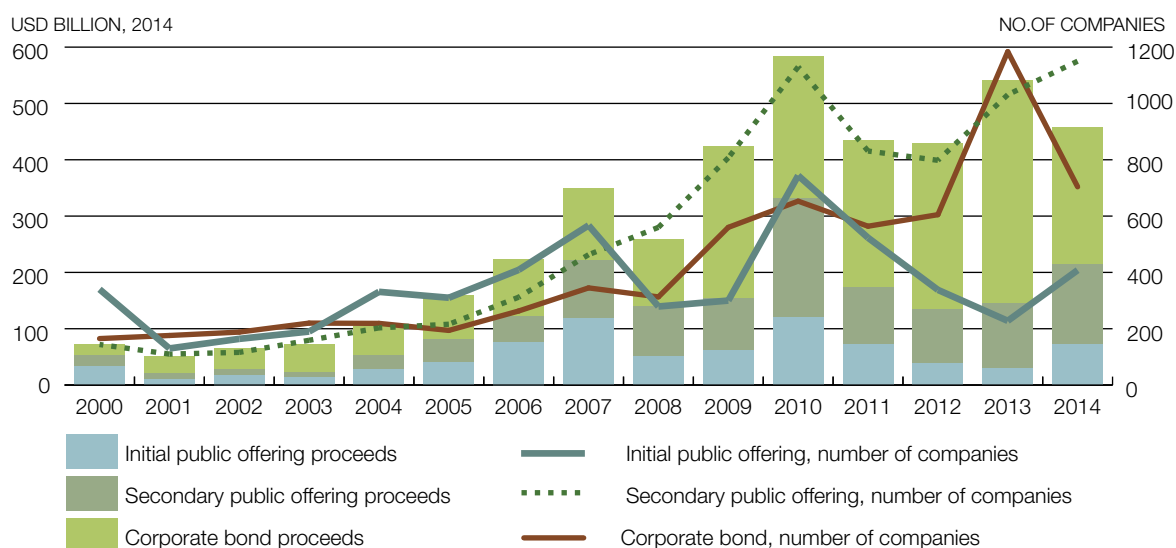
Strengthening market-based financing of corporate investments

During the last ten years, corporations' use of capital markets has changed in a number of important ways. These changes have partly been driven by macroeconomic events that have affected traditional sources of funds and shifted some of the corporate debt from traditional bank lending to corporate bonds. They may also have been influenced by regulatory changes that have contributed to a decrease in the use of public equity markets by small and medium-sized enterprises. In a low interest environment, where institutional investors are pressed to meet their client obligations, corporations have also had to respond to investor campaigns for higher dividends and share buyback programmes.

Main findings

- Following a drop after the financial crisis, the number of shareholder campaigns has remained at a fairly stable level. Between 10% and 15% of all shareholder campaigns are focused on demands for buyback programmes and dividends.
- Since the financial crisis, the United States and Europe have both seen a marked increase in the issuing and outstanding stock of corporate bonds.
- Since 2008, companies from emerging market economies remarkably increased their use of capital market-based financing. Between 2000 and 2014, the total amount of money they raised through capital markets increased more than five times, reaching USD 458 billion.
- Further study is required to determine whether any regulatory initiatives may have contributed to a decrease in the number of small size companies that use public equity markets to raise capital.
- The profound changes in the functioning of secondary equity markets and trading practices over the last decade raise important policy issues with respect to ensuring level playing field among investors and efficient price discovery.

Figure 11. Capital market financing of non-financial, emerging market companies



Note: See page 20.

Source: Thomson Reuters, OECD calculations, see Annex 7.A1 for details.

Figure 11 reports that non-financial companies in emerging market economies remarkably increased their use of capital market-based financing, from USD 73 billion in 2000 to USD 458 billion in 2014. The number of companies that raised funds has also significantly increased over the same period.

Chinese companies represent by far the largest increase in both absolute and relative terms among emerging market companies. From a nascent corporate bond market prior to 2008, Chinese issuers have during the last four years raised an average of almost USD 125.

CHAPTER 8

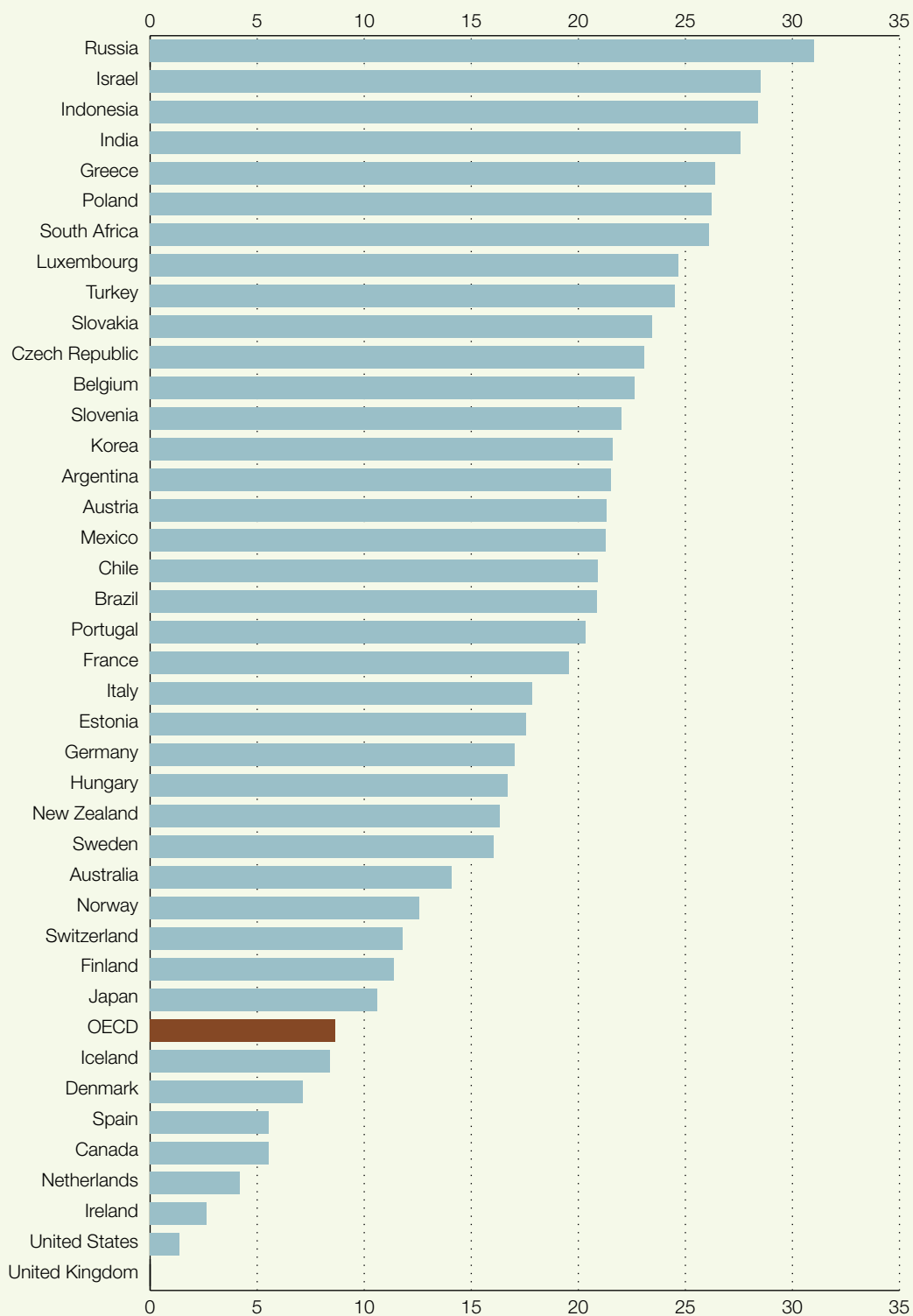
Pro-competitive policy reform for investment and growth

Promoting competition was declared to be a priority by the G20 in 2014, recognising that it is market competition between firms that provides them with an incentive to reduce costs and develop new and better products. The economic evidence shows that some of the most effective structural reforms to promote growth are those increasing product market competition. On the other hand the most damaging restrictions on competition often arise from protected state-owned enterprises (SOEs) or from regulatory policies that unnecessarily limit competition. Since state ownership is becoming more significant in the world economy, it is increasingly important to ensure that SOEs face similar competitive conditions, on equal terms, as do private sector firms. Identifying and redesigning the most damaging regulations can be difficult and, in many cases, politically challenging. Quantification of benefits and accounts of other countries' experiences can help explain and gain political support for reforms. Some cases are described here.

Main findings

- In the absence of competition, firms face little incentive to innovate and to invest to improve productivity growth. Inefficiency resulting from weak competition could be an important factor in weak economic growth overall.
- Government restrictions on competition, for example through protecting incumbent state-owned firms or through regulation or undue financial advantages, can be particularly damaging to innovation, investment and growth.
- State ownership is becoming more important in the global economy, mainly because of the increased share of emerging economies with large state-owned sectors, particularly (but not only) China. The scope for anti-competitive distortions from this source is therefore increasing, unless state-owned enterprises can be subjected effectively to competition, and to effective systems of corporate governance.
- For regulatory distortions, the devil is in the detail: reform at the “big picture” level of removing formal barriers to entry may not be enough. Growth-enhancing reform needs to work through the large stock of specific regulations that have anti-competitive effects if it is to be effective.
- Removing such restrictions to promote growth need not result in short-term costs. Some deregulatory initiatives to promote competition, such as liberalising trading hours (for example, lifting restrictions on Sunday trading) can generate new employment opportunities and economic expansion.

Figure 12. Potential GDP gains by 2060 from product market reform (%)



Note: See page 20.

Source: OECD Economic Outlook, May 2013.

Pro-competitive structural reforms could raise aggregate output by about 9% in the OECD area. Analysis by the OECD using the Product Market Regulation Index suggests that product market reform has very significant potential to raise GDP in most economies: by as much as 30% in some large emerging economies.

NOTES TO BE TAKEN INTO CONSIDERATION WHEN INTERPRETING THE DATA

- Figure 1. This figure reproduces Figure 2.5 in the OECD Business and Finance Outlook 2015. Note: a) Commercial Bank loans and leases for the United States; M4 sterling lending for the United Kingdom; MFI & Euro-system loans to euro area residents for the euro area; aggregate bank lending (excluding Shinkin Banks) for Japan.
- Figure 2. This figure contains data from Figures 2.6 and 2.9 in the OECD Business and Finance Outlook 2015. Notes: Europe refers to the European Union and Switzerland.
- Figure 3. This figure reproduces Figure 3.1 from the OECD Business and Finance Outlook 2015.
- Figure 4. This figure reproduces Figure 3.11 from the OECD Business and Finance Outlook 2015.
- Figure 5. This figure reproduces part of Figure 3.17 from the OECD Business and Finance Outlook 2015. Note: The 34 covenant variables in the dataset are matched to the 15 covenant groups. If a bond had at least one covenant that belongs to a certain covenant group, it was considered to have that covenant type. For each covenant type, a binary variable was generated, which is equal to 1 if the covenant type is available in the bond indenture. The binary variables are then summed, divided by 15 to create an index that ranges from 0 to 1, with the ratio 1 denoting the highest possible protection for bondholders. Data from the binary variables frequency in selected sub-categories are shown in the bottom panel. * Asset sale restrictions are very highly correlated with cross-default provisions and merger restrictions, the latter two of which are not shown.
- Figure 6. This figure reproduces part of Figure 4.18 in the OECD Business and Finance Outlook 2015.
- Figure 7. This figure reproduces part of Figure 4.12 in the OECD Business and Finance Outlook 2015. Note: Assets accumulated and annuity payments are calculated for the same hypothetical individual contributing 10% of wages over a 40 year period and then retiring. The assets are invested in a portfolio comprising 60% of variable income and 40% of fixed income. The return on both asset classes used is 4.5% for the former and the historical yields for 10-yr government bonds, kept to maturity, for the latter. The assets accumulated are used at retirement to buy an annuity 20 years making payments for starting at age 65 and using the actual government bond yields for calculating the annuity premium. The only variable evolving over time is the yield on government bonds which is set equal to actual data. Therefore, the evolution of both variables represents the impact of interest rates trending downwards since the 1970.
- Figure 8. This figure reproduces part of Figure 4.13 in the OECD Business and Finance Outlook 2015. Note: The historical long-term US government bond yield is used to discount the cash flows. The yield in 1970 is used for the present value of the first year. The yield for 2014 is used for calculating the present value of the last year.
- Figure 9. This figure reproduces Figure 5.1 in the OECD Business and Finance Outlook 2015. Note: a) Commercial Bank loans and leases for the United States; M4 sterling lending for the United Kingdom; MFI & Euro-system loans to euro area residents for the euro area; aggregate bank lending (excluding Shinkin Banks) for Japan.
- Figure 10. This figure reproduces Figure 6.9 in the OECD Business and Finance Outlook 2015.
- Figure 11. This figure reproduces Figure 7.7 in the OECD Business and Finance Outlook 2015. Note: The definition of secondary public offering or follow-on (SPO) covers all share issues of listed companies after an initial offer.
- Figure 12. This figure reproduces Figure 8.3 in the OECD Business and Finance Outlook 2015.

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The post-crisis behaviour of much of the economic system poses a risk puzzle:

why do so many people managing the listed companies that carry out a large portion of the world's capital formation see so much risk on the horizon while so many major players in financial markets apparently see so little risk? Someone will inevitably be proved wrong. How do we avoid a crisis when this happens?

This booklet reproduces highlights from the first edition of the OECD Business and Finance Outlook which examines many of the issues that will have to be addressed to ensure that the challenges can be handled smoothly. It looks at the way in which companies, banks, other shadow banking intermediaries and institutional investors are trying to deal with a climate of very low interest rates and structural change in the global economy. The “promises” of growth, employment and adequate retirement income are seen to be at risk in the absence of policy actions.

Find the OECD Business and Finance Outlook online at
www.oecd.org/daf/oecd-business-finance-outlook.htm

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