



**Eurofi 2008 -
Thursday 11/09/08**

**Session [11D] - THE ROLE OF
LONG TERM INVESTORS FOR
INCREASING FINANCIAL
STABILITY.**

The Panel

Moderator: **Daniel Lebègue**, Co-Chairman, Eurofi

Panelists: **Angel Gurría**, Secretary general, Organisation for Economic Co-operation and Development (OECD)

Eddy Wymeersch, Chairman, Committee of the European Securities Regulators (CESR)

Hervé Carré, European Commission, Director General, Economic Affairs

Alfonso Iozzo, President, Cassa Depositi e Prestiti

Jean Sebeyran, Secretary General, Caisse des Dépôts et des Consignations

The Debate

Daniel Lebègue, Co-Chairman, Eurofi, said long-term investors had played a major and positive role in this financial crisis. "They contribute to the resistance of the banking system, and capital markets. In some cases they have preserved some major banking actors. At the same time, some of these long-term investors lack transparency regarding their strategy, which raises questions. What are their real objectives? What about their governance? The transparency of their operation?"

Angel Gurría, Secretary General, Organisation for Economic Co-operation and Development (OECD) first considered the definition of long-term investors.

A long-term equity investor was one prepared to hold shares for as long as a company takes to realise its long-term potential. This could take a long or short amount of time, depending on the governance of the company. Alternatively, for pension funds, long-term investment could mean accumulating assets to meet their life-cycle commitments.

"Long-term investing requires pools of capital that will take equity stakes," said Mr Gurría. "As recent experience suggests, unlimited debt financing can be problematic at certain points of the cycle. So who are the potential long-term investors?"

The total OECD pensions market was around \$24.6 trillion in size. By comparison, sovereign wealth funds added up to around \$2.6 trillion. Mr Gurría said they were growing very fast and in 10 years it was thought that sovereign wealth funds would be worth \$10 trillion-\$12 trillion.

"The numbers are huge by any count. The most fundamental requirements to attract these funds are stable regulated markets, stable, macroeconomic policies that do not generate excess liquidity, and sensible regulation and competition policies that give some guarantees of a level-playing field."

However, he said we had seen over the past year that such policies were not a foregone conclusion. "The current crisis gives a good opportunity to focus on improving better macro, and better, not necessarily more, regulation." He said the Financial Stability Forum had made some excellent recommendations on this matter.

OECD countries had understood the importance of engaging sovereign wealth funds as responsible investors. "When people get all worked up about the sovereign wealth funds, you're talking about something that is a tenth of the pension funds waiting to be invested. It's essential that they play a part in recycling wealth. These are, after all, the mirror of the so called global imbalances. We didn't solve the imbalances so now we are dealing with the consequences. It's a natural continuity."

Mr Gurría noted that you could attract global investors with an open investment regime. The successful pension funds like the Norwegian pension fund were mostly invested abroad.

"OECD members are committed to non-discriminatory regimes that welcome foreign investors. These are the poor countries," he joked. "The US, Germany, Italy and France. OECD ministers welcome the contribution that sovereign wealth funds make to the economy. The sovereign wealth funds have been reliable, long-term, commercially driven investors, and a force for global financial stability. OECD countries pledge not to erect protectionist barriers to their foreign investors."

If national security issues were to arise, any restrictions should be transparent, predictable, proportional and clearly defined to face clearly defined risks. "But don't use the national security excuse to stop transactions of a commercial nature," he warned.

"This didn't start with the sovereign wealth funds saga. We had already been working on a freedom of investment, because three years ago among the OECD, you couldn't buy a bank, you couldn't buy an electricity company, you couldn't buy a yoghurt company. That was the wrong way to go."

With assistance from the International Monetary Fund, sovereign wealth funds had drafted their own governance code. It would be about

Nice, September 2008

THE THINK TANK DEDICATED TO FINANCIAL SERVICES IN EUROPE

11 bis, rue Mansart - 75 009 Paris - FRANCE - Tel.: +33 1 40 82 96 03 - Fax: +33 1 40 82 96 03 - www.eurofi.net

transparency, and should provide a means for all market participants to consider whether they provide a basis as constructive investors.

Mr Gurria stressed: "No OECD country reports any type of predatory or negative activity by any of the sovereign wealth funds. Whenever people start imagining what could go wrong, that's exactly what they are doing, they are imagining! We don't have any evidence of predatory behaviour. Frankly, if somebody tried, it would be stupid because we are in the OECD. We have the best legal, political, and financial defences in order to stop them doing that. After all, you are talking about them investing in our sovereign territories, where we are sovereign and we can decide on things."

So, he asked, where did the fear come from? The most significant intervention of sovereign wealth funds had been the stakes they had taken in Western banks, which allowed those banks to raise sufficient capital to avoid bankruptcy. This had been an important stabilising influence. However, Mr Gurria said this was where it got complicated. Banks could not accept funds only to tell their beneficiary to then 'go home'. "It doesn't work like that."

With regards to the regulatory framework, he said, long-term investors would take a hard look at whether it encouraged good corporate governance. "The OECD rules of corporate governance provide a global standard for regulators and stock exchanges. The OECD guidelines are governance code for state-owned companies. All these countries who own companies are generally observing them."

Mr Gurria said most of the largest pools of equity, such as pension funds, insurers and sovereign wealth funds, diversified their exposures. "The Norwegian fund has 7,000 individual investments, barely any of them have more than 1pc. They don't want to control the companies. It's an investment." He added that when you have \$1.7 trillion you might want to invest more than 1pc, because there would not be a stock exchange big enough to buy less than 1pc. "Here, like in other things in life, size matters," said Mr Gurria.

Finally he urged the group to look at the evidence and see the objective, economic consequences of long-term investors, which are fundamentally on the right side.

Eddy Wymeersch, Chairman, Committee of the European Securities Regulators (CESR) started by distancing CESR from his comments. CESR was not, he said, involved in the sovereign wealth fund business, so his comments were his own opinion and not those of his organisation.

Mr Wymeersch sought to look at the subject not from the financing aspect, but from the angle of control of the companies. "We need to define this control structure very clearly, and determine to what extent the sovereign wealth funds are controlling companies."

This, he said, was the crux of the matter. "We know this phenomenon of holding companies for a long time. They are usually family holdings, which have been in existence for a long time, they have significant stakes, and they look at the long-term. In their monetary function they are extremely useful. That's one of the reasons our European companies are so different from the US, overall they are more stable."

However, he sought to make the distinction between financial and strategic investments. "The denominator is not the funds, it is the influence. We can measure that influence. Size matters all the time."

Mr Wymeersch asked: what could be the potential negative aspects? "If we are talking in political terms, then you see China, or the Russian oligarchs coming. They may be there in buying distribution systems for oil, for instance. You must be careful that you do not assimilate everything and do not focus too much on financing."

There was a clear advantage in having long-term investors, which were a stabilising force, but "we have new classes of long-term investors and these are not the usual pension funds but the activist pension funds, and other activist investors." The actions regarding corporate governance employed by pension funds and other investors, like the Association of British Insurers, had escalated. "They exercise power; they are not only in the business of financing."

He said hedge funds were another class of investor exercising power. "Then you see it is not exercising power solely to improve corporate governance. Some of these hedge funds take action on the business plan of the organisation in which they invest. Deutsche Börse is a good example. We have to be careful that we see how this power is exercised. Not only with sovereign wealth funds but any shareholder that is exercising power in companies."

Mr Wymeersch said the General Accepted Principles of Practice (GAPP) would be published in October. This would be based on a framework for global governance and accountability arrangements, and was the line he would like to see followed everywhere.

"Suppose you have a sovereign wealth funds with bad intentions. It will of course keep them secret. After a while, they increase their participation, they have more active members on the board, and they start to infiltrate. Then what do you do? I think we have to devise an alert system. If you have one of the Russian oligarchs in your company and they become a little bit more aggressive, you should have somebody on the board who says there is something going on. This is an issue that should be taken into account. You could do that within the organisation of the company itself."

The UK, France and Germany had announced some restrictions on investments. "That is not a good idea," said Mr Wymeersch. "The US

Nice, September 2008

THE THINK TANK DEDICATED TO FINANCIAL SERVICES IN EUROPE

11 bis, rue Mansart - 75 009 Paris - FRANCE - Tel.: +33 1 40 82 96 03 - Fax: +33 1 40 82 96 03 - www.eurofi.net

has used that power on many occasions. You have the same problem in China. That being said, Neelie Kroes, the Commissioner for Competition, has announced a pre-emptive strike. Once she saw that Germany were mounting defences, she will intervene in that discussion on the basis of her competition powers.”

Hervé Carré, Director General, Economic Affairs said the European Commission was very active in the work of the OECD and shared its conclusions. “The reality of the modern financial system is that the vast bulk of transactions take place for reasons of risk management, not trade or investment,” he said. “The risk management vocation of the financial system has stimulated the creation of new financial actors, and the creation of new and often complex financial instruments and techniques. We have seen the likes of hedge funds, private equity funds, and sovereign wealth funds emerge and become active players in the markets; with new instruments like [collateralised debt obligations], and CDO squared.

This kind of new players, techniques and instruments had allowed risk to be managed more effectively, and had allowed it to be spread across a wider number of participants. “This is the reason for the reduction in the premium required for taking on risk, and the corresponding willingness for the financial system to assume a higher aggregate level of risk.”

Long-term investors could now share their risk. The greater risk sensibility had created greater volume in financial flows. Amid all this short-term activity, the long-term investor was no longer required to bear all the risk of the investment over a long time horizon and therefore was more willing to undertake certain investments.

“The outcome from a macro-economic perspective is more investment and higher lending and investment to the benefit of productivity,” said Mr Carré. “But recent experience has shown, it is always possible to have too much of a good thing. It is probably reasonable to conclude that the experience of last year points to some imbalance between investors with short-term horizons and high sensitivity to risk, and investors who are in for the long haul.”

Excess global liquidity had been an important contributory factor. But there was a need to consider whether the regulatory and accounting framework had also played a role. Many of these issues had been highlighted in Ecofin’s road map and in the Financial Stability Forum recommendations. “We must examine whether our financial framework encourages excessive risk taking in search of profit in an economic upswing, followed by the need for excessive risk aversion in a downswing.

“We must also consider whether fair value accounting, which has been introduced for very legitimate reasons, does not cause investors to take a short-term view, even if they would prefer longer-term investment horizons.”

Sovereign wealth funds could be seen as long-term investors and therefore could be seen as potential stabilisers in the international financial system. “To ensure that they can play this role and to avert protectionist actions, the European Council agreed on a co-ordinated approach to sovereign wealth funds.”

Sovereign wealth funds had already made a significant contribution to resolving the current turmoil by injecting capital onto the balance sheets of several financial institutions, Mr Carré said, even if subsequent losses had made them more circumspect.

“We must not forget that they are to a large extent a by-product of the current system of international exchange rates. This is associated with large and persistent global financial imbalances. The accumulation of assets, even recycled through sovereign wealth funds, cannot justify the maintaining of inappropriate exchange rate regimes.”

He recognised the concern among recipient countries about the lack of transparency of governance arrangements. “Many sovereign wealth funds are not regulated directly or indirectly, and they remain opaque regarding their strategies and their internal checks and balances. Sovereign wealth funds may have the potential to contribute adversely to financial stability. Moreover, if they could pursue broader objectives, rather than just maximising their risk-adjusted returns, their investment activities may distort price mechanisms.”

These concerns would be alleviated if and when sovereign wealth funds became more transparent, publicly disclosing their investment strategies. This was the objective of discussions at the international working group and the objective of the GAPP. In return, the recipient countries must agree to a stable and predictable investment regime for sovereign wealth funds. “I am confident that this process of mutual confidence building will be a success thanks to discussions being led by the OECD,” concluded Mr Carré.

Alfonso Iozzo, President, Cassa Depositi e Prestiti said the discussion had reminded him of a book written in the US after the Depression. The book analysed the shifting of power in companies from the shareholder to the manager. “Now are we going back from the manager to the shareholder?” he asked.

Managers were not able to raise capital in the normal way on the stock exchange, and so they needed some long-term committed investors. As a result he suggested there might be a shift in power back to the shareholder. “But if this is true, we must ask what are the actions and the role of the shareholders?”

During the recent crisis, the banks that had made the biggest errors generally lacked strong shareholders. In Europe, he said, banks with stronger shareholders were much more cautious. “Why? Because if you

Nice, September 2008

THE THINK TANK DEDICATED TO FINANCIAL SERVICES IN EUROPE

11 bis, rue Mansart - 75 009 Paris - FRANCE - Tel.: +33 1 40 82 96 03 - Fax: +33 1 40 82 96 03 - www.eurofi.net

have long-term investors you are not forced by the market to push short-term results.”

He complained that long-term investors were not able to do their job anymore. Families could play a role, but it was not possible for them to have the role they had played in the past. There was a need for more long-term investors. It was not surprising that those coming into the market were not investors but public governments, said Mr Iozzo. There were substitutes, such as foundations. Cassa Depositi e Prestiti had made a lot of long-term investments, such as the building of railways in Italy.

“The opinion makers say it is important to have some investors looking to the long-term. The market can’t cover everything. This is the framework in which we have to act. In this sense I think it is important that we in Europe are starting to think about how we are organising the market.”

He recalled the bigger crisis of the 1930s, which created the idea of the management taking over the companies. The crisis resulted in the creation of a lot of institutions, such as Fannie Mae and the World Bank, that played a big role in rescuing the economy. In a certain way, we had to go back to this experience, said Mr Iozzo.

“We need a New Deal for the economy. I am very afraid when I hear in Europe people say we have to push forwards because otherwise we are not increasing our production. Nobody is asking what we really need. Do we need new cars in the US? I don’t think so. We need more public transport, not more cars.”

However, he said, if we gave money for people to spend and sustain the economy, there would be more cars in the streets with the resulting traffic meltdown and pollution problems. This did not need to happen. If investors were able to fund the public transport system in Europe, they would.

All investors, when they invested abroad, would need government support sooner or later. The regulatory framework should not be seen as a negative but rather a positive factor. Good sovereign funds needed to know that they were investing in a country where the government would support them, and they would be able to stay.

Jean Sebeyran, Secretary General, Caisse des Dépôts et des Consignations sought to describe the role of the new long-term investors. Financial markets gave no proper consideration for long-term needs. They put the emphasis on mark-to-market needs and risk management, which were not the right criteria to have a long-term position in the economy.

“Low interest rates have allowed investors such as private equity funds and hedge funds to enhance their activities on a financing basis. When the financing basis happens to disappear we run into problems.” Financial institutions had made use of new techniques to trade risk, but in the knowledge that there were stable and long-term investors in the market.

“What we discovered is that we have a lack of liquidity.” Central bankers now had to get the bad risk from the banks. Then, long-term investors were needed to bring stability to the markets.

Mr Sebeyran said there was a need to rediscover the benefits of long-term investments for the economy. “Classically, long-term investment was to benefit long-term industrial processes. Long-term investment is now needed to finance research, and to be a permanent and stable investor in corporate firms. That means that if a long-term investor is a permanent and stable actor, it will be in a position to back the corporate growth plan and the same long-term view as the corporate firms.”

Long-term investors were now in a position to give some kind of structural liquidity to the market, aside from market regulators and central bankers. He recalled a comment by the Governor of the European Central Bank, who said that there was no need to kill the securitisation business. We just had to be more transparent, and more responsible. “To keep the securitisation business we need to have long-term investors, able to sustain that kind of product.”

There were four criteria to define a long-term investor.

- 1) The investment horizon should be over 10 years and it should be monitored between 10 and 20 years
- 2) Long-term investors would accept regular profits spread out over time. Focusing purely on short-term objectives was fine in an upswing, but meant that everything would stop in a downswing. “We have to make the effort to shift to a longer view of the flow of profits in the future,” he said
- 3) Sufficient resources to meet liabilities
- 4) A very clear philosophy of investment, which should be shared by the management and the board. Management should be able to ask their investors for commitment over a long-term period.

“How do we combine the proper balance between short-term IFRS reporting, and long-term objectives, which should be the proper reporting?” he asked. “I know that it takes a long time to convince the board to shift from the classical one year, one semester reporting, to a five or 10-year view in reporting.”

Secondly, he asked how one should evaluate long-term objectives for the global and long-term return? How to appreciate volatility over a long-term period? “Those issues should be elaborated with economics. That is why Caisse de Dépôts is ready to create a permanent dialogue between long-term investors, with no regard to whether they are public or private. All of them agree to consider those as key issues to restore mutual confidence and give proper economic reward to long-term investors. More long-term investors are very important for the new economy.”

Nice, September 2008