

For an EU action plan to remove the disincentives to long-term investment



1. Stable investments are required in order to reap the high risk-adjusted rates of return offered by long-term projects.

The value creation of long-term projects stems in particular from the introduction of new technologies or products (e.g. new sources of energy, infrastructures, new technologies...). Such projects are associated with long-term increases in productivity or in general welfare and leads in turn to an enhanced and sustainable development of GDP. This value creation offers high long-term risk-adjusted rates of return.

The growing use of "renewable" energies, the reduction in the production of carbon dioxide by the economy, modernization and extension of transport systems, and the development of the infrastructures required to meet the specific demands resulting from the ageing of the population all represent some of the urgent needs for investment which are leading to greater opportunities for creating value as well as financing requirements. Moreover, the effort to bring down public debt offers increased opportunities available to private sector savers and intermediaries – investment funds, insurers, pension funds, etc. - to fund long-term investments in the place of or in support of the public authorities that previously used to finance a major percentage of these projects.

These stable investments - generally for periods much longer than five years and often involving buy-and-hold strategies either in equity or in long-term debt instruments – are required to actually reap the value-creation that results from the well-designed long-term projects. They should therefore be attractive to savers/investors that do not pay too much attention to the short-term volatility of their investments but rather focus on long-term value creation. Nevertheless, over the past decade the focus has become more and more on short-term market investment strategies, even in the case of financial institutions that have few or no liabilities maturing in the short and medium term.

2. Due in particular to current regulatory framework and financial reporting standards, investors and financial intermediaries massively adopt a short-term focus that is detrimental to long-term projects and to financial stability.

Today many investors have a short-term focus because of such factors as the private markets' emphasis on quarterly performance reporting, fair-value accounting, regulatory rules for capital and liquidity, and managers' incentive compensation. This is a key cause of 'herd behaviour' and pro-cyclical asset prices. In the upswing of the credit cycle, accelerating credit growth can cause asset overvaluation. Conversely, in times of stress operators that share a short horizon may try to sell assets simultaneously, causing market liquidity to evaporate. The experience of the recent crisis has shown that such behaviour can severely undermine financial stability.

In particular current regulatory evolutions actually deter investors to hold equity and other investments with a long-term investment horizon. For example Solvency II assesses the "value at risk" of an asset that an insurer holds for hedging long-term commitments through its one-year VAR rather than the value that is likely to be achieved on this asset when it needs to be realised to clear the related long-term commitments. As a consequence equity-holdings one-year value is their 40% discounted current market value and Insurers are dramatically reducing their equity holdings.

If ever Solvency II-like legislation were imposed on pension institutions – whose average maturity of liabilities is even longer than in life-insurance – those institutions could be forced to dramatic selling of their equity holdings. Next to such a hypothetical detrimental development in the prudential regulatory framework, there is the current proposal of the IASB (Exposure Draft on IAS 19, April 2010) to abolish the existing option of smoothing the effect of unrealised losses and gains in the balance sheet of the sponsoring company to Defined Benefit schemes. Such an abolishment would damage the – already decreasing – provision of Defined Benefit schemes by corporate plan sponsors.

Yet if enough investors with a medium to long-term horizon -- including insurance companies, pension funds, university endowments and charitable trusts, sovereign wealth funds, and individual savers -- are active in the financial marketplace, they can increase liquidity, reduce asset price volatility, and act as shock absorbers in times of financial stress. Indeed, the differences in their portfolio behaviour from that of asset holders with a short time horizon increases market liquidity. Long-term investors can also enhance financial stability by buying undervalued assets in times of stress and selling them in periods of 'market exuberance' when they are overvalued from a long-term perspective.

It is therefore important that fiscal, regulatory and accounting rules do not bias the behaviour of investors towards short-term goals. On the contrary, the stabilizing capacity of medium-and long-term investors should be reinforced by measures that encourage diverse portfolio behaviour. This would also favour enhanced and sustainable long-term growth of productivity and GDP, and enable investors and individuals to benefit from high long-term risk-adjusted rates of return.

3. Adaptations of prudential regulations and accounting standards factoring in the horizon of investors and intermediaries' liabilities deserve to be looked at further

Accounting standard setters and prudential supervisors share a common goal, which is to provide an accurate picture to investors, counterparties, and supervisors about the performance and risk profile of a financial institution, factoring in all available information.

With regard to insurance, pension funds and -- more generally -- investors holding liabilities with a specific (and long) maturity, management must be assessed by ensuring the suitability of the characteristics of their liabilities with those of assets. This must be the constant concern for management, accountants and prudential supervisors. Measures of performance should not just provide a snapshot of an institution independently of position of its portfolio in the credit or liquidity cycle, but also reflect its risks and likely rewards over its life.

In this way, accounting and prudential requirements that attempt to accurately reflect the economy for long-term investments should start off from the expectation of the valuation of these assets at their maturity, and compare this against the expected value of hedging assets at the same maturity.

These assessments must take into consideration not only the risks associated with each asset class, but also the economic cycles affecting their value and the management measures that may reduce differences for the duration of

the hedging investment. In many cases, counter-cyclical approaches such as the smoothing of gains and losses over time or using more stable discount rates may better reflect the nature of long-term investments.

In the same vein one would suggest an accounting approach that could add for a third category of long-term assets to the current accounting model which separates assets and liabilities into those held for trading activities (fair value) and those where the intention is to hold them to maturity (amortised historical cost). Such a third category could cover financial and real investments that are held over a medium/long-term outlook and managed based on an economic valuation factoring in the horizon for holding them, on an expert's judgement and on stringent internal and external validations by auditors and supervisors.

4. In conditions where prudential and accounting requirements for financial intermediaries may inadvertently create disincentives to long-term investment, the structuring of a long-term financial infrastructure (financial intermediaries and instruments), directly siphoning off savings and more generally global investment capacities to long-term projects, would contribute towards meeting the growing needs of Public-Private Partnerships (PPP)

With PPPs, the industrial partner (sponsor) is subject to many constraints: long operating periods, strict compliance with deadlines for delivery, technical and operational performance, commercial risk, etc. However, in addition to the industrial guarantees that are already leading sponsors to group together in consortiums, they are also being asked for guarantees in terms of long-term financing and equity contributions, which, set against the backdrop of a reduction in public financing, would require an increase in the number of financial partners available, notably in line with the growing number of industrial consortiums bidding for projects.

It is important to add that these constraints must be seen against a very high and indeed rising level of requirements for infrastructure financing – renewable energies, urban development, transport, new technologies, particularly IT, support for long-term care in view of the ageing of the population, etc. – at the very time when the need to reduce public debt levels requires private financing to play an increasingly important role.

Thus the development of possible financial partners must move forward while taking into consideration the fact that new prudential requirements (which we recommend adjusting to the specific features of long-term investments) are increasing the equity requirements for banks very significantly, which is reducing their lending capacities and resulting in more expensive loans over shorter periods.

This context therefore indicates that, alongside the usual financial partners – banks, insurance companies, pension funds, etc. – financial partners such as private equity or investment funds, securitisation funds, Sovereign Wealth Funds etc. would increase the proportion of PPPs financed with equity or fixed-income products through private capital.

The development of such long-term financial partners will also be made easier by the strengthening of secondary markets for these types of equity interests, since the non-liquidity of investments in PPPs represents a further factor holding back their development (see below).

Sufficient standardisation of PPPs is crucial to the emergence of such secondary markets, whether they are organised or over-the-counter. Moreover, this standardisation is necessary in order to address the growing number of PPP operations, often on small scales.

At the European level, it is desirable to put in place practices such as the following:

- A standardised approach for the assessment, and the distribution (including its formalisation) of a PPP's risks between the public authorities and private partners, in addition to
- A standardised mechanism for reporting on PPP performance that would make it possible to establish a common language with a view to accelerating the establishment of such partnerships from both an industrial and a financial perspective, while helping ensure the financial fungibility of such investments.

Public insurance and guarantee mechanisms as well as additional analysis by credit rating institutions on the financial risks that are specific to long-term investment would also contribute towards this financial fungibility. They are likely to clarify the long-term investment risks and prevent an inappropriate gap between the proposed return on investment and the effective risk.

In the best interests of savers as well as industrial partners, such partners must of course have the capabilities and expertise required in view of the specific features associated with long-term investments, particularly when structuring projects in innovative fields. Furthermore, the presence of recognised public financial partners, such as the EIB, the Caisse des Dépôts et des Consignations, the Cassa Depositi e Prestiti and the KfW, when raising funds would represent an additional confidence building measure to encourage financial partners to become involved and to facilitate the coordination of secondary markets for securities that finance investments in long-term projects.

5. Special savings vehicles at European level could foster long term investment

Long-term securities generally have a higher risk-adjusted return than those with a short time horizon, and therefore should be attractive to savers who also have consistent long-term wealth accumulation goals. However, the liquidity of these instruments is typically low, which is viewed as a disadvantage by savers in most cases even when their financial needs are purely long term. As a consequence private savers in Europe usually prefer short and medium term investment instruments.

The challenge is to overcome this attitude by encouraging savers to make longer-term investments as far as their financial means and needs allow them to do so.

Therefore we propose to consider the creation of a EU regulated investment vehicle particularly for long-term investments of private households. It should be a well-regulated vehicle with many qualities that have made UCITS a highly regarded product – safekeeping of assets by a depositary, diversification, transparency and governance standards. Different from UCITS, however, it should not be subject to the requirement to redeem units as requested by holders. The aim is therefore to promote a EU standard for closed-ended vehicles, as with French or Luxembourg "SICAF" funds.

Without the requirement to accept redemptions permanently, the vehicle could invest in real assets and long term financial instruments that are not listed and less liquid. This would help to finance long-term projects, and allow the savers to benefit from the higher returns that such assets regularly offer

The investments that these vehicles make should not be marked to market (if possible at all) but their valuation should rather factor in their discounted cash flow. This would avoid inappropriate fluctuations of the NAV whenever it is calculated for purposes of financial reporting or redeeming units.

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In order to offer at least a certain liquidity for their units or shares held by investors, the vehicles could accept redemptions with certain restrictions – e.g. only certain amounts per year, after initial holding periods, with notice periods etc.

In addition, organising the trading of the units on a secondary market could provide some liquidity. Lastly, this "quotation" also would enable such long-term vehicles to target institutional investors that are subject to regulatory constraints requiring the securities they invest in to be listed.

One alternative that allows a low level of volatility and ensures a higher frequency of redemption for units could be (cf. German open ended real estate funds) requiring such funds to hold a certain level of liquid assets. However, this last model is less well suited to institutional investors, which are subject to the mark-to-market approach.

6. The tax treatment of equity holdings also deserves the regulator's attention

Equity finance is generally used for higher risk and higher return investments such as long-term investments. Any disadvantageous tax treatment of equity finance, compared with debt finance, may tend to hold down profitable investments.

Most tax systems favour debt finance over equity, since interest is deductible against corporate profits, but dividends are taxed. As a consequence, this lowers the after-tax cost of capital of debt-financed compared to equity-funded investments. Although equity finance allows corporations more flexibility to undertake fixed investments since it does not impose strict repayment conditions, the more favourable treatment of debt may lead to less effective capital structures and encourage excessive indebtedness. Neutrality of financing choices should not necessarily be achieved by removing deductibility of interest payments, but by granting equivalent advantages to equity financing.

In this context, governments could introduce an Allowance for Corporate and Project Equity (ACPE). The ACPE applies a nominal interest rate to a project or company's total equity capital and reduces the tax base. As a consequence, the effective tax rate can be greatly diminished, depending on the capital structure (Debt / Equity ratio).

ACPE plans currently exist in Belgium – the "Notional Interest Deduction" --, and have existed in Austria, Croatia, Italy, and Brazil. In Austria, the plan was withdrawn after some years in the context of a reduction of the overall corporate taxation rate. In Belgium, a survey on the impact of the "Notional Interest Deduction" was conducted among businesses, with respondents highlighting the main achievements of the scheme:

- Lowering the overall tax rate
- Reinforcing shareholder's equity
- Maintaining or increasing economic activity and investments and attracting foreign direct investment
- Restoring Belgium's fiscal competitiveness vis-à-vis other countries
- Positive impact on employment

Other alternative initiatives are the Equity Tax Credit (Canada), which offer income tax credits to individuals investing in eligible businesses, and which can be carried forward for 7 years or back for 3 years.

7. A tool-kit enabling issuers to reward Long Term Investors

Even if stable investments eventually benefit from high risk-adjusted rates of return, issuers have to play their own role to encourage such investment behaviour. Indeed they need to enforce policies that:

- Align shareholder and management objectives
- Refocus value assessment on "fundamental value" to balance instant "market sentiment"
- Secure Strategic Investors in difficult times...

Issuers also need to reward investors with a Long-Term orientation in order to

- Postpone costly dividends
- Facilitate future share issues
- Reduce shares' price volatility notably by reducing share borrowing practice

Several initiatives suggest possible ways forward: Extra voting rights (France), extra shares (LLyod, Air Liquide, etc.), extra dividends (L'Oreal, etc), and reducing frequency of financial reports... A possible tool would also be a loyalty-share programme by which only the shareholder having kept their shares for several years receive warrants allowing them to subscribe as new share. In 1991 Michelin replaced a dividend payment by such mechanism. The CEO motivated it at the time by saying: "Long-term oriented shareholders, who hold on to their shares during the difficult but critical time the company is facing [will thus be rewarded]"

Such possible initiatives suggest precisely describing and promoting at the European level a set of tools enabling issuers to appropriately reward the stable investors.

8. A plan for long-term investment in Europe

On the whole, European Union Member States are faced with a growing need to use private financial resources, including those of European savers as well as non-EU foreign investors. Indeed, actions to deploy new infrastructures and renewable energies, to address the challenges associated with social measures to factor in European demographics, to provide the volumes of financing required for European businesses set against a tightening up of banks' prudential constraints, etc., all represent opportunities or threats concerning the potential for European growth which must be addressed within the specific framework of the constraints stemming from high levels of public debt.

With continued high volatility in capital markets, these countries are on the whole faced with the need to establish the conditions for greater financial stability, which specifically require the development of a stable investor base.

The Europe 2020 strategy put forward by the Commission is intended to enable EU to come out stronger from the crisis and deliver high levels of employment, productivity and social cohesion.

The Commission's legislative agenda offers numerous opportunities to include the specific features of long-term investors into the regulatory framework: revisions are underway concerning international accounting standards for valuing assets (IAS 39/IFRS 9), calibration of the Solvency II Directive, and revision of the UCITS Directive.

