

The G20's possible role in fostering the projects serving sustainable growth



This document was drafted by Eurofi with input from its members. It does not engage in any case the French Presidency of the G20 or the French financial authorities.

Sustainable growth in developed or emerging Economies is driven by multiple long-term projects

1. The value creation of long-term projects stems in particular from education, research and the introduction of new technologies or products (e.g. new sources of energy, infrastructures, new technologies, schools, etc.). Such projects are associated with long-term increases in productivity or in general welfare and lead in turn to an enhanced and sustainable development of GDP.
2. 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 demographic trends, all represent some of the urgent needs which are leading to greater opportunities for creating value.
3. The effort to bring down public debt makes it necessary to associate the 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.

These long-term projects represent opportunities for investors

4. But to meet these needs, it is important for such investments to be financed by investors which are patient and stable. Indeed those projects need investors who can participate in financing with a timeframe that is consistent with the nature and the requirements of physical investments, commit funds throughout the project development phase, effectively understand the nature of the operation's risk and adjust their financial support as needed throughout the duration of the capital investment project.
5. These long-term and stable investors are those looking to benefit from the specific value creation, which characterises long-term projects, which offers high long-term risk-adjusted rates of return as those returns follow the trend of the GDP. Moreover, those returns are also freed up from significant short term market-volatility and from the cost of temporary illiquidity risks. For households, such long term investments fit the saving needs on at least five key areas: retirement, possible future real estate acquisition, wealth transmission, financing aging people's assistance and future education needs. Given the ageing of populations, the OECD highlights the need of long-term investment vehicles (pension schemes, insurance products, etc.) to hedge related longevity risk and promote retirement products providing a stream of income after retiring.
6. On the other hand, 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.

However, economies are short of stable investors

7. The allocation of capital to long term investment remains sub optimal. Many institutional 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, solvency, and liquidity, managers' incentive compensation, tax systems, lack of tailored investment vehicles. This is a key cause of 'herd behaviour' and pro-cyclical asset prices. This short-term focus frees them up from long-term risks, but heightens the short-term investment risks, the scale of which has been revealed by the current financial crisis. This trend is all the more problematic as in many countries Treasury instruments are far from being as safe as they were considered a few years ago.
8. The level of shares held is falling and turnover within portfolios is gaining pace. This preference for liquid, short-term fixed investment vehicles is well reflected, at the micro level, in the investment holdings of institutional investors. As stated by OECD in the Eurofi newsletter, "while they should have a key role to play in channelling savings to financing long-term productive activities - in OECD countries, they held over USD65 trillion at the end of 2009 - data for the OECD region suggest that their investment holding periods have gone down from about 5 years in the 1980s to less than 10 months in recent years" though it is not clear from this aggregated data whether this is a consistent phenomenon across asset owners or simply reflects larger volume of turnover across a small segment of the market.

Reducing economic uncertainties to extend prudential regulatory horizons

9. Financial risks can be estimated over longer horizons only in geographical areas with sustainable growth and reliable financial stability. In the context of macroeconomic imbalances (budgetary, current accounts imbalances, excess liquidity) and continued rise in volatility on the financial markets, regulators reduce the horizon to evaluate risks and as a consequence increase the focus of financial institutions on the short term. For instance the use of Value At Risk at 1 year to measure the solvency of insurance companies in Europe (Solvency II) and the proposal to eliminate the option for smoothing unrealised profits and losses on "defined benefit schemes" (IAS 19) illustrate this trend.
10. Similarly banks with mainly long-term investment approaches consider that the unique set of assumptions underpinning the recent Liquidity Coverage Ratio do not factor in the specificities of their assets and the subsequent actual strong renewability of

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their funding. In this respect the exclusion of equities from the list of the admitted high-quality liquid assets would induce shortening investment horizons and inappropriately favour Treasury instruments.

11. Therefore to encourage the development of stable investors, public decision-makers must first seek to establish the conditions for sustainable and balanced growth. That is why the G20 measures to identify national and global economic imbalances early and define corrective actions that are supported by the Mutual Assessment Process (MAP) are decisive and must be put in place as quickly as possible. Furthermore regulators should ensure they do not add short-term barriers to the long-term instruments held by institutions.

Complementing the accounting and prudential frameworks by “Risk Statements (RS)”

12. Simultaneously as developing long-term investment is a condition for growth sustainability and financial markets stability, policy makers should focus in parallel on reducing short-term focus among investors and supervisors.
13. As a complement in particular to ongoing efforts to reduce the volatility and the pro-cyclicality of market value based accounting rules, one could propose to complement the current accounting and prudential information with forward-looking statements that provide them information going beyond current short-term horizons. Such description should make it possible for investors and supervisors to take into consideration the long-term situation of the entity despite the growing volatility of the financial markets, which currently reduces the legibility of financial statements.
14. To inform on the opportunities and risks that result from management decisions of financial institutions, the economic context and the specificities of the liabilities of each institutions such forward looking statements should have the same high quality, transparent and reliable standards than those of the current accounting and regulatory statements. These statements should be extensive and consider all the long-term risks faced by companies, including those rose by climate change, etc. – directly through input and production disruption and indirectly through regulatory risk.
15. Most companies produce useful information that is dispersed over financial reports, annual reports, investor presentations and other specific documents. However, the current information is often criticized, as it is costly and insufficiently clear. We are proposing to create specific and common accounting and prudential statements that should provide such information for each investing institution.

Reducing existing disincentives for investing in equities and developing investment vehicles in long-term projects

16. Equity finance is generally used for investments that contribute to a sustainable development of GDP such as long-term investments.

Most tax systems induce imbalances between debt and equity finance, since interest is deductible against corporate profits, but dividends are taxed. In the international context interest is often exempt from domestic withholding taxes whereas dividends are not. Even where tax treaties reduce the rates, the relief is often difficult to obtain due to procedural issues. 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.

17. Neutrality of financing choices should not necessarily be achieved by removing deductibility of interest payments, but by granting equivalent advantages to equity financing. The solution is to engage toward tax reforms reducing distortions to business decisions, in particular regarding indebtedness.
18. Long-term project managers also need to reward stable and patient investors. This is why there is a need to describing and promoting a set of tools enabling issuers to appropriately reward the stable investors e.g. loyalty shares (L-Shares), extra shares, extra voting rights, extra dividend, etc. As a counterpart institutional investors should strengthen their role as active shareholders with a long-term orientation and particular regard to sustainable corporate development– as outlined in the OECD’s work on corporate governance. Either as result of their fiduciary duty or as a way to improve the returns of their investments, institutional investors’ role as responsible shareholders is key to ensuring the necessary monitoring and engagement that promotes efficient use of capital and corporate decisions oriented towards sustainable growth and appropriate risk management. They should in particular be considering the impact of long-term risks, (see above Risk Statements) on their investment portfolios.
19. The liquidity of investment vehicles (life insurance products, investment funds etc.) is viewed as an advantage by savers even when their financial needs are purely long term. As a consequence private savers 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 regulated investment vehicles for long-term investments of private households.
20. These vehicles should replicate many qualities that have made UCITS a highly regarded product. But in addition such vehicles should, as with French or Luxembourg "SICAF" funds, not be subject to redemption obligations in order to allow them to invest in real assets or long-term financial instruments that are not listed and less liquid. They would not either be permanently marked to market to free them from the inappropriate fluctuations of their Net Asset Value that funds normally have to permanently provide to allow daily redemptions. Last in order to offer a sufficient liquidity, intermediaries could also organise the trading of their units or shares held by investors on a secondary market.



- 21. It is also essential that the fund industry constantly put investors' interests and protection at the forefront and plays its part to strengthen the role of long-term savings. In that regard, the quality and independence of advice given to the end investor at the point of sale by distributors is key – as is the need to educate individual savers on the risks of a short-term focus for their savings and the opportunities which their low liquidity constraints can open up for them. This requires the industry to offer appropriate transparency to investment products. The fund industry must simultaneously address the issue of short-termism that is driven by the fact that although asset managers manage long-term assets they tend to be evaluated on short-term results.
 - 22. Lastly, in terms of public infrastructures and public services, the emergence of sustainable growth requires the development of successful public-private partnerships (PPP)¹. Such public-private partnerships are long-term contracts and/or legal entities built up by a public authority and the private sector for delivering a long-term (or less frequently short-term) asset or a service.
 - 23. As highlighted in the OECD² an optimum sharing of risks between the public and private sectors represents a necessary condition for the development of such partnerships, which can effectively contribute towards the financing of public services and infrastructures. This sharing requires the best practices used in this area to be distributed globally. It also requires the public-authorities commitment. To this end they should set up consistent specific guarantees and financing mechanisms e.g. insurance mechanisms, project bonds, public and private specialised investment funds, dedicated saving mechanisms benefiting from public guarantees, systematic hurdle rates for financing public and private partnerships, etc.
 - 24. The capability of institutional investors to invest in long-term assets should also be further strengthened by enhancing governance mechanisms and practices and creating opportunities for collaboration among public and private investors in order to make direct investments in infrastructure, low carbon projects etc.
- 2. Ask the IOSCO to develop guidelines for a specific regulatory framework to complement existing savings products by investment vehicles targeting the high long-term risk-adjusted returns specific to long-term assets, leveraging in particular the reduced liquidity demand, which is specific to long-term savers and for the alignment of financial intermediaries' incentives with savers long-term interests.
 - 3. Ask the OECD, in cooperation with other relevant international bodies and stakeholders, to develop further work and report back to G20 on policy options to promote longer-term investment and savings as main contributors to sustainable growth; and in particular:
 - Ask the Organisation to assess the impact of structural measures on the size and composition of global capital flows;
 - Advance recommendations to favour stable long-term investment;
 - List the best fiscal practices which eliminate the incentives encouraging excessive leverage and debt, as well as the disincentives which penalise investments in equities including in the international context;
 - Define good practices for sharing risk and financing between the public and private sectors for the development of public services and infrastructures, and enhancing the role of institutional investors
 - Set out the priorities for informing and educating savers as effectively as possible on the benefits of long-term investment and savings, and to develop further related guidelines, including through its International Network on financial education.

G20's role to encourage financing for sustainable growth

Eurofi suggests that the G20 of finance ministers and central bank governors:

- 1. Asks the IMF, Basel Committee and FSB to set prudential and accounting frameworks that do not induce unintended and inappropriate disincentives to long-term investment, and analyse the possible complementary prudential regulations and accounting standards as a "Risk Statement (RS)" to better assess and inform investors, managers of companies and supervisors on the actual long-term risk and encourage the development of long-term investment

1. See OECD - Principles on Private Sector Participation in Infrastructure, <http://www.oecd.org/dataoecd/41/33/38309896.pdf>
 2. Ibid.



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Financial reporting and long term investment. Improving transparency while supporting the conditions for long term investments.

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The primary objective of financial reporting is to provide users with objective, transparent and relevant information. Transparency is about understanding performance, financial position, cash flows and risks.

Performance information, based on historical data, should portray how the business is run and reflect management decisions and their outcomes. Risk assessment requires more forward looking dynamic information such as sensitivity analyses and the potential impact of financial and economic changes, including stress scenarios.

The same information set cannot simultaneously meet both the objective of portraying historical performance and the goal of identifying risks. Accordingly, different types of information are needed to provide transparency on (1) how managements have discharged their stewardship of their businesses over the preceding period based upon their stated business model and (2) what the potential impact of economic and other risks are on future performance.

For example, for long-term investment (equity or debt instruments) neither fair value accounting nor historical cost with impairment can adequately address both the objectives to provide information on performance and to provide information on risk. Indeed, fair value measurement does not represent the performance in relation to the objective of a long-term investor to the extent that the holder is willing and able to hold the investments for the long term rather than having to dispose of it at the current market price. The market value also raises issues of relevance and reliability for unlisted equity investments held for the long term, or when the size of a position is such that the quoted price may not be an adequate representation of value. In the above cases, the performance that is relevant to the investor is the net income generated in the period i.e. dividends or interests less holding costs and impairments as well as profit/loss upon ultimate sale. Fair value is also not an adequate measure of the risks associated with the investment since the cash flow sensitivities to risks are not fully represented by the current market value. The fair value merely provides the measurement of one possible scenario among many and hence falls short of providing adequate risk data.

Greater clarity is needed to distinguish performance reporting from risk reporting. We suggest that the debate on the accounting model be disconnected from the legitimate concern to provide relevant

information on risk. The accounting model should focus on performance measurement. Additional and separate risk data should be provided to help respond to the legitimate risk transparency expectations of users and also provide users with understandable, accessible and relevant risk information disclosures.

The accounting model should focus on performance and be based on the business model/purpose, and we suggest the creation of a separate risk statement as a new primary statement to help to respond to the legitimate risk transparency expectation and the need for robust risk information.

The accounting model should be business model based.

In order to provide any stakeholder with a relevant assessment of where the institution stands, accounting of financial instruments should reflect management decisions and their outcomes.

The performance and cash flows of a lending activity will be different when they are part of an activity in which loans are originated with the intention of holding them to maturity as compared with cases where loans are to be sold (or packaged for sale) quickly on a secondary market. The time horizon is an essential element of the business model and should be reflected in the accounting treatment.

In most cases, an entity's business model is not a voluntary designation but rather a matter of fact that can be observed from the way the business is run and managed over time. Changes of business models can happen if the way the business is run is modified. There should be transparency of the business models designated by management by adequate disclosure as well as information on the risk and funding profiles.

The business model employed should be the primary factor in determining how best to report performance and cash flows. In other words, the accounting for financial instruments should primarily reflect the way the business is run and managed and not be predetermined solely by contractual characteristics of the instrument. In that sense IFRS 9, which amends IAS39, is a step in that direction but does not quite go far enough because the contractual characteristics of financial instruments continue to be given significant weight resulting in departing in certain circumstances from the business model. Recent announcements by the US FASB, if implemented, would allow a greater use of the business model. Under the model suggested in this paper, the risks stemming from the contractual characteristics of financial instruments would be addressed in the separate risk disclosures.

The IFRS 9 solution departs from the business model approach for long term investments by requiring equity securities to be measured at fair value through either earnings or equity without the possibility to recycle gains & losses into the income statement.

The use of fair value to measure the performance of long term equity investments does not appear relevant because it does not portray an underlying business model where the investor is not expected to sell the instruments in the short term. A potential enterprise failure that

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would require liquidation of the long term equity investments at fair value is not relevant to the accounting of performance because of the underlying going concern assumption. The risk statement will provide risk information that would support this assumption, including information on liquidity and funding. If such investments are significant such information would be critical to an understanding of the business model and would be disclosed in a risk statement.

Fair value raises issues of relevance and reliability, as illustrated above. On the other hand, cost information less impairment does provide reliable and objective information on the performance of an equity investment held for the long term (dividends and funding costs together with any profit or loss on disposal). It does not however provide information about the future cash flow and can fail in some circumstances to reflect fully the long term performance of a long term investment by not recognizing any long term sustained increase in value which may result in increased dividends and will be realised when the investment is disposed of.

There is no perfect solution for the measurement and performance reporting of equity investments held for the long term; however the solution that should be selected should be the one that best reflects the performance of the investment under the business model employed knowing that the risk statement will provide adequate risk information about future cash flow expectations and variability.

The need for a clear, concise and focused risk statement.

To better respond to the legitimate risk transparency expectation, it is proposed to create a risk statement which will provide information on risks in a summarised quantitative way. It would be a new primary statement in addition to the existing statement of income, financial position and cash flows.

The creation of a new statement, the "risk statement", would allow to address the concern about the level of attention paid by users/investors to the primary financial statements (financial position, income, cash flow) and the lack of accessibility of/less attention paid to the notes to the financial statements which contain a significant amount of information about risks. Accordingly, it would facilitate access to risk information currently spread across various sections of financial statements and management discussion and analysis.

Where fair value provides relevant risk information on business activities not accounted for at fair value, it would be a part of such risk statement.

Accounting standards, regulators and policy makers already require that financial institutions disclose risk information in their financial reporting. Most companies provide this disclosure either in their financial reports, annual reports, investor presentations, or in other specific documents - e.g. for banks, Basel Pillar 3 information.

However, the current risk disclosures reporting model is often criticized both by preparers and users. Preparers complain about the increasing amount of information that need to be disclosed while

users consider that the information provided does not enable them to have a clear understanding of risks, which leads to a demand for even more information.

Part of this paradox might come from the fact that the risk information is not presented in a concise and focused manner. Indeed risk information is often spread out over different sections of financial reports with some duplication; qualitative analysis explaining why a risk exposure has increased or what the specific risks that require special attention are not developed. The objective of the risk statement would be to consolidate in one place all of the critical risk disclosures. It would seek to show this information in a clear, concise and focused manner as a primary statement.

A first step in the design of a risk statement would be to consolidate in one place the risk disclosures that are already required and that are critical. This would permit to identify amongst the already required disclosures those that could be disregarded going forward and the additional risk disclosures that would be useful. Part or all of any additional risk disclosure requirements should be principles based and defined by financial institutions based on their business models and specific circumstances.

