Long term Investors Club
Cassa Depositi e Prestiti
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Long term investment: what appropriate regulatory framework?

We don't need to expand on the importance of long term investment. All factors point in that direction:

- in mature countries, there is a pressing need to finance innovation, environmental programs, as well as to prepare for the consequences of an ageing population;
- in developing countries, the income per capita catching up process is requiring vast investments in infrastructure (transportation, energy…).

These needs are huge. Given the scarcity of long term finance, the competition for capital will be intense. Emerging countries with high saving rates will be increasing their domestic demand. They will need to import more long term capital especially in the form on direct investment. Indeed their financial markets are insufficiently developed and, in spite of their large current account surpluses, they will be relying for quite a long time on "global" financial funding.

What can we do, in our so-called "advanced" economies to incentivise long term investment?

There are several ways to address that question.

1. <u>One is to ensure a more balanced macro economic setting</u>

Large US current account deficits, matched by emerging countries surpluses, combined with a systematic pegging to the dollar of their currencies, has produced negative effects from the standpoint of long term investment:

- emerging countries savings have been used to finance US consumption (not investment),

- word-wide abundance of liquidity combined with lax monetary policies has kept interest rates low, which has deterred investors from long term projects.

One could add that the increase in US current account deficits and the accumulation of external reserves has tended to attract huge amounts of finance invested in relatively short term treasury investments.

It is clear that such imbalances require significant adjustments:

- a shift from exports to domestic demand in emerging countries,
- some "savings mending" in mature countries, associated with fiscal consolidation (i.e. the reversal of public sector dissavings which would mitigate the crowding out effect of excessive budgetary deficits).

All this points to the crucial importance of macro-prudential surveillance destined to reduce unsustainable imbalances and asset bubbles.

Let us not forget that in a world awash with liquidity the pace of private investments has been suboptimal, the "excess savings" having ended up in treasury bills or asset bubbles like in the mortgage markets. It is clear that the low interest rates prevailing over the last 15 years has favoured the search for risky financial investments that offered a more attractive return.

But, better macro oversight - important as it is - is not the only way to address the problem. Let us now concentrate on regulation.

2. <u>Regulation should provide the "right" incentives for long term investors</u>

It is sad to observe that the regulatory setting has most often been providing negative incentives to long term oriented investors.

a) <u>For a very long time, tax incentives have systematically favoured debt versus capital</u>. The tax exemption of interests has been a powerful instrument to encourage debt. In spite of all the politics involved in housing matters, I believe that tax neutrality would restore a level playing field and would therefore eliminate biases against long term equity investments decisions [1].

b) <u>Another set of short term oriented incentives is related to the combination of the prudential and accounting systems.</u>

Accounting rules that are appropriate for investment banks and trading activities are irrelevant for holding long-term investments.
Investors (intermediaries) main economic function is to achieve the best backing of liabilities with a view to unwinding related assets under sound conditions when contracts mature in order to satisfy the rights of its creditors. These maturities are

[1] See Financial Times: "Taxing debt like equity would make our banks safer", by David Walker. May 27, 2010.

spread over variable horizons, ranging for instance from a few months for supplementary health cover to 15 to 30 years for life insurance and pensions…

In this context, current accounting standards involve two conceptual difficulties: in the IAS Board's philosophy, a company's assets and liabilities must be valued separately and independently; second this valuation must be based on current values (marked to market).

This specific valuation approach (IAS 19 for pension funds, IAS 39 for banks and insurers…) is particularly damaging for long-term investments. Indeed it consists in attributing instant market values to assets the value of which is by essence based on several years. By doing so, market volatility is immediately transferred to investor's balance sheet and profit-and-loss account. Moreover, the current accounting reporting system does not make it possible to check the quality of the fit between assets and liabilities. For instance it is questionable whether short-term fluctuations in interest rates and asset prices should immediately be recognized since occupational pensions have long-term commitments.

These two difficulties represent a major disability for financial communication in terms of the investor and supervisory authorities, as well as for customers, intermediaries, shareholders, etc. The accounting rules set up for trading activities do not take into account the differences between business models of financial institutions.

Impact of solvency standards on long-term investment: example of Solvency 2

The principle for an economic valuation of assets, liabilities and risks underpinning Solvency II is based on the assessment of a general increase in the risks faced (more volatile financial markets, more frequent and more intense natural disasters, increase in competition between players, complex trends in terms of life expectancy, dependency, illness, etc); this principle also meets the need to incorporate into supervision the technical progress made in terms of risk assessment and already adopted by insurance companies.

However, at the time of its conception, the perspective was focused too exclusively on liquidity aspects, introducing a major limitation into this approach. This unrealistic perspective requires checks to ensure that there will be "enough money at hand" to be able to pay all the compensation due to policyholders, not a the term of their policies, but if the business were to be shut down at the end of a one-year period (one-year VAR principle). This verification is particularly unsuitable since the assets and liabilities are valued not based on an estimate of this value at the time the assets and liabilities are realised, but based on their immediate value (MtM). This short-term horizon would eliminate practically all stock holdings in insurance companies. In a country like France, this represents a major contraction in the demand for equity [2]. In the UK, domestic pension funds and life insurers have run down their share of the UK equity market to 25-30% [3]

[2] Life insurance is the favourite placement of French households (41 % of their total financial investments, i.e. 1.200 billion euros in 2008). The stocks held by French insurance companies amounted to 352 billion euros in 2008, i.e. 40 %

In addition this combination of the 1 year Value at Risk and the instant fair value principles included in the European Directive, irrespective of the duration of the given insurance line leads to pro-cyclicality, contrary to the traditional contra-cyclical role of insurance investors. Insurers should have done more to break the recent fall of the equity markets because of the very nature of their liabilities and their low liquidity constraint. Counter intuitively they had to reduce their equity exposures to manage their increasing capital needs.

From this perspective, the revision of the European directive defining prudential standards for pension funds must be approached with great care, and must not trigger the spreading of these mistaken principles that threaten both long-term investment and financial stability more widely.

Possible adaptations of regulations

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 banking 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 checking the suitability of the characteristics of their liabilities with those of assets. This must be the constant concern for management, the stakeholders preparing the accounts and prudential supervisors. Measures of performance should not just provide a snapshot of an institution at the peak of the credit or liquidity cycle, but also reflect the risks and rewards over the life of the portfolio.

In this way, an accounting standard looking to accurately reflect the economics for long-term investments should start off from the probabilised valuation of commitments at their maturity, and compare this against the expected value of hedging assets at the same maturity.

This valuation 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. Counter-cyclical approaches like smoothing of gains and losses over time or using more stable discount rates would better reflect the nature of long term investments.

The accounting or prudential standards must clearly be in line with a perspective aimed at the continuity of operations, which means that the fair value of an asset held for hedging regulated commitments is neither this asset's acquisition value, nor its mark-to-market value, which offer only partial information, but the equivalent value which will probably be able to be achieved on this asset when it needs to be realised to clear the commitments it covers on the insurer's balance sheet. In this context

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of the Paris market capitalisation. Because of the new regulations (60 % capital requirements for shares held by insurers), these figures are crumbling.

[3] See Financial Times. March 3, 2010, John Plender "The pensions shake up heralds equity demand change".

being transparent and subject to strong internal and external validation by auditors, supervisors and other constituents is key.

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In conclusion, I would like to stress:

- the intense competition for long term finance that will characterize the world in the coming years;
- the sensitivity of long term growth to the cost of capital [4].
- the absolute need to eliminate regulatory disincentives against long term investment;
- the urgency of avoiding excessive regulatory zeal (the piling of too many ratios and capital requirements would endanger the transformation and intermediation capacity of our banking systems and make long term credit less available and more expensive, especially in Europe where bank credits play an overwhelming role in financing the economy);
- the risks of overburdening private equity funds and especially those that are not public, and in which investors are locked in for several years. Such funds have not cost anything to the taxpayer (the proposed Alternative Investment Fund Directive appears, in this respect, way out of its reach). It is well established [5] indeed that there is a significant correlation between a well developed private equity and venture capital market, and the creation of new firms in the most dynamic sectors. Is it really a good idea to discourage banks and insurance companies to invest in such crucial enterprises (research, innovation, SME's) contrary to the Lisbon requirements?
- the importance of looking at insurance companies for what they are: i.e. long term risk takers and long term asset holders. If enough investors with a long term horizon were active in the financial market place, they could act - as they used to - as shock absorbers i.e. increasing liquidity and reducing volatility though buying in depressed markets.

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All these disincentives are man made. They are not given and untouchable principles. They can and should be changed. This requires clear thinking and political leadership.

Jacques de Larosière

[4] The OECD (May 2010 Report) has calcutated that about 2 percentage points of the 3 % projected reduction in potential output in the OECD countries in the coming years in relation to the crisis will come from a higher cost of capital which reduces the capital-labour ratio and hence productivity.

[5] See ECB working paper n° 1063-2009. A. Popov and R. Roosenboom "Does Private Equity Investment Spur Innovation? Evidence from Europe"