



*Warsaw, Paris, Roma, Frankfurt, February 24, 2011*

## **Contribution to the consultation on the EU "Single Market Act"**

As representatives of European long term investors with public mandate, we have been during the last two years raising awareness in the EU and international fora on the necessity to promote long term investments in order to fight against financial markets imbalances and foster a sustainable growth.

We therefore very much welcome the impetus, given by the Commission through the Single Market Act, to the promotion of a framework adapted to long term investments.

Indeed, it will take a long-term vision to tackle major challenges facing our society: climate change, scarce natural resources, ageing, urbanization, and education. Exit strategies for the economic and financial crisis must be developed on this basis. Given their multiplying and social cohesion effects, targeted investments in transport, energy, low carbon and telecommunication infrastructures as well as in innovation and training projects could play a key role in growth and jobs creation strategies.

The needs for long term investments by 2020 will be huge. Be it only in the field of transport and energy infrastructures, these needs are valued at 1600 billion Euros by the European Commission assessments.

As public resources are scarce, the European Union will have to increase its leverage on global markets. Given global monetary imbalances, the demand for euro- denominated instruments from emerging countries with liquidity surplus might rise significantly. Moreover, long-term investors such as pension funds, insurance companies, sovereign wealth funds , large not-for-profit funds and similar institutions will be searching for long-term and low-risk instruments. This type of long-term investors holds assets valued at over 50 trillion dollars. If only a few percentage points of their portfolios were to be invested in European initiatives, it would constitute a potentially massive amount of funds for financing growth-stimulating investments.

The question, then, is **how to lift obstacles to attract this capital?** To do so, the EU should, according to us, move in two directions:

- 1- develop new, long-term financial instruments;
- 2- create a common regulatory framework favourable to long-term investment.

It should be stressed out that the first proposal is totally depending on the second one. Unless short termist obstacles are lifted, resources to finance long term financial instruments will not be available.

## **I. Creating new long-term financial instruments mixing public and private funds**

### ***A. Creating equity and debt long term financial instruments***

#### **1. On the equity side**

**Instruments mixing resources coming from European institutions** ( i.e. the European Commission, the EIB or the EIF) **and public and private financial institutions** established in Member States could be developed on the same model as the Marguerite Fund (2020 Marguerite Fund for infrastructure, energy, transport and climate change) or the InfraMed fund for the Mediterranean region.

In order to maximize the leverage effect of the EU budget these equity funds should not be aimed at addressing exclusively market failures since it would send a wrong signal to the market. They should rather address sub-optimal investment situations while enabling attractive return on investment, in line with the EU 2020 objectives.

#### **2. On the debt side**

Our institutions are currently analysing the needs for and opportunities of using **project bonds or other initiatives on debt supported by ad hoc guarantee schemes**.

Indeed, the reputation and the technical skills of European long-term financial public institutions– with the endorsement of the EU - may have a powerful credit-enhancing effect on the instruments needed to finance the huge demand for strategic investments in Europe.

**Financial innovation**, in particular securitization, can also play a useful role in this kind of risk sharing strategies. Several schemes of securitization can be invented in order to transfer risk from banks to institutional investors. Transport and renewable energies infrastructures, the revenue of which is stable, are well suited to securitization. Indeed, institutional investors could buy senior debt portfolios from banks guaranteed by revenue flows coming from these projects. These acquisitions would be financed by the emission of standardised long term bonds. These emissions should be sufficiently numerous in order to ensure the depth and liquidity of the market.

The feasibility of creating **long term saving vehicles at the European level** could be also examined. These financial instruments would take in portfolio both debt and equity financing, alongside traditional financial players (especially banks). This would include establishing a legal framework for developing ad hoc long-term investments funds (such UCITS or mutual funds) strong and attractive enough to capture European long-term savings but also those of sovereign wealth funds, pension funds and third countries. To ensure the sustainability and solvency of these funds, a risk measure and a prudential regulation adapted to these longer-term instruments would be put in place.

### ***B. Developing fiscal incentives***

In order to attract capital on this long term investment vehicles, coordinated European fiscal incentives for long-term investments may have a very powerful role. The US has given a prominent role to new financial instruments, such as the Build America Bonds, with

strong fiscal incentives to attract domestic and foreign savings to finance infrastructure, energy, and social and urban initiatives.

Similar fiscal incentives of equity and debt may be one direction to take for Europe as well. Indeed, 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 regard, we welcome the recent initiative by the Commission to set up a Working Group on EU fiscal harmonization, including the taxation of financial activities.

## **II. Creating a regulatory financial framework better designed for the promotion of long term investment**

As for the new common regulatory and legal framework, much can be achieved in the near future. Regulatory and accounting standards, a common best practice in PPP and new rules for corporate governance, may become the main pillars.

### ***A. The First pillar: prudential and accounting standards.***

While not all types of long term investors are fully subject to IFRS and Basel Committee rules, the latter can have serious impact on their investment potential through at least two channels:

- Long Term Investors (LTI) maximise their effectiveness if the banking system is ready to leverage their action on long term investment with a complementary attitude;
- historical experience suggests that market participants and rating agencies benchmark the capitalization of institutions with peculiar regulatory status vis-à-vis the Basel principles.

#### **1. Rules on liquidity and capital requirements**

We believe that in an asset-liability management perspective, the Basel III proposals do not take into account the specific features of LTI liabilities. LTIs have high-quality financing instruments and less volatile resources than other financial institutions. In the case of a liquidity crisis, they generally benefit from the “flight to quality”. Therefore, we underscore that a large proportion of LTI financing sources, especially deposits, should be considered as “renewable” whenever conducting a liquidity stress scenario.

Moreover, other specificities must be taken into account when assessing the impact of a liquidity stress. In particular, for project-financing credit lines, disbursement is conditioned on technical requirements related to project progress. These facilities are indeed subject to a lower disbursement risk than that of classical banking revolving credits.

There are, moreover, two other important concerns in this regard: the way shares are treated and the fact that the leverage ratio should not become part of Basel's first pillar but second pillar.

Regarding the deduction of investments in financial companies, the scope of consolidation should be revised under the CRD and the new Directive on 'Financial conglomerates'. An enlarged scope of consolidation should lessen the impact of this deduction.

## **2. Accounting standards**

Finally, like many other long-term investors, our long-term financial institutions welcomed G20 calls for a valuation of financial instruments based on their liquidity and on investors' holding horizons, taking into account valuation uncertainty. However, the standard for financial instruments (IFRS 9), as published in November 2009, and the related proposals of the International Accounting Standards Board (IASB) on impairment and hedge accounting, does not give enough prominence to the investor's holding horizon criterion. Accounting standards should give more prominence to the business model criterion with regard to the classification and measurement of financial instruments and provide for a simplified hedge accounting model reflecting the economic reality of the risk management.

## **3. Solvency II and rules applied to insurance sector**

Special attention should be paid to prudential regulation (Solvency II) and accounting standards (IFRS) for long term institutional investors such as pension funds and insurance companies. They are potentially huge players for long term investments. Regulation and accounting rules should be partially revised to increase such potential and to better represent their long term nature.

Life insurances and pension funds are characterized by long-term and very long-term liabilities. Accordingly, they tend to invest with a long-term horizon, and their asset allocation basket includes items that are perceived as "rich" in the long run. Their asset allocation process differs from that of a generic asset manager since, for these institutions, liabilities matter and consequently hedging instruments for the liabilities enhance investor's utility. Moreover, for a long term investor the concept of risk diversification contemplates the time diversification in addition to the cross-assets diversification.

The profound changes in the risk management of insurance companies, brought about by the increasing complexity and variety of risks over the last two decades, have made it necessary to revise prudential regulations (Solvency II) and to adapt the international accounting standards (IFRS).

More generally, while nobody would dispute the value of having a real view of the impact of the primary financial and actuarial risk factors on an insurance company's accounts, we feel it is regrettable not only for the insurance sector and pension funds but for the economy as a whole that the fair value of assets and liabilities be a basis for analysing the financial soundness and solvency of insurance companies.

For most of their activities, insurance companies and pension funds have long-term or even very long-term liabilities that in turn justify long-term allocation. Life insurers are

estimated to control US\$ 11 trillion of assets under management. But because of their liability profile, their low risk appetite and their decision making structure, the estimated allocation to illiquid investments is of only 4 %. Therefore, measuring their solvency on the basis of short-term values is not only incompatible with the need for investment in assets that, while risky, yield very positive average long-term returns, but also means that any genuine asset-liability management is an illusion, even though the regulators actually hope to promote ALM.

Short-term constraints on pension funds have been criticized not only for being prohibitively costly, but also for being mostly irrelevant for long-term investors that do not face short-term solvency concerns. This stands in stark contrast to banks, where the risk of client runs justifies the short-term focus. Because banking corporations borrow short and lend long, transforming savings into longer-term investments, they are subject to liquidity risk when clients exercise the implicit put option on their deposits. Pension funds, on the other hand, have the unique ability to behave as very long-term investors, not only because the liabilities they face typically have a very long horizon, but also, and more importantly perhaps, because long-term ties bind employers and employees. After all, pension fund benefits are a by-product of the employment contract, and not a competitive financial service, and this prevents the risk of client runs: employees may be able to surrender their pension contracts only by breaking their employment contracts, an option that is rarely exercised in a massive collective fashion.

Therefore, in order to limit negative consequences of prudential reform on the capacity of insurance companies to finance economic activity, two types of actions could be envisaged:

- Reinforce the contra-cyclical character of measures proposed in Solvency 2; ,
- extend the principle of a reduced charge rate to contracts with very long liabilities as retirement contracts.

***B. The second pillar: setting up a European framework in order to promote and exchange best practices in public private partnerships (PPP) financing.***

As many OECD Reports have shown, private and foreign investment in PPP also requires a good and stable regulatory framework, with reasonable regulatory and bureaucratic costs, an efficient and technically skilled public administration and government services, and a reliable judicial system. In many European Countries, better regulation is the first requirement for attracting private and private/public foreign investment. A common framework may then be very important to reduce regulatory and non-financial risk. We all know that regulatory risk is a very large part of the cost of financing and of the feasibility of large project financing initiatives. We also know that regulatory frameworks are nationally determined and thus that harmonization in this area is very difficult as it involves legal systems that differ greatly. However, sharing best practices is a good first step towards a more harmonized framework. The practice demonstrates that public PPP centres well placed in institutional framework contribute to rationalization of regulatory framework and education of public administration.

***C. The third pillar: corporate governance.***

The corporate governance model of the so-called “shareholders’ value” is partly responsible for the short-termism that characterized recently global capitalism. Such a model places the maximization value of the shares at the centre of the stage, even before the industrial or social value of the firm. The model of the firm is conceived as a mere “nexus of contracts”. The management is contractually linked only to the shareholders and not to the workers, or to the stakeholders or, more generally, to the industrial future of the firm. The firm becomes then an abstract concept, and not a “community” or an “organism”, as it was conceived in other past traditions, notably, in Continental Europe or in Japan and Korea. The managers of the firm are “winners” if they maximize the value of the shares, which is directly related to generous bonuses and stock options. This mechanism has created strong incentives to maximize short term, rather than long term, value.

For all these reasons we strongly support the recommendation of the *Single Market Act* to launch a public consultation (Green Paper) on corporate governance. Further work should be done on the variety of different types of legal status (foundations, cooperatives, mutual associations, etc.) to propose measures enabling the quality and the transparency of the legal structures concerned to be improved in order to optimise their functioning and facilitate their development within the single market.

A special action on remuneration could be efficiently taken. Indeed, investment professionals’ time-line regarding their remuneration and career is generally disconnected from the investment horizon of the projects they are working on. Long term Investors should therefore put mechanisms in place in order to reduce this mismatch. For the 2020 Marguerite fund for infrastructure, energy, transport and climate change for example, the incentives of the advisory team are based on long term performance criteria and are fully consistent with the general principles of long term performance endorsed by the G20. This practice could serve as a basis to build up a more balanced bonus policy.

The fact that long term investors themselves hold shares in companies should also be taken into account. As such, they should act as responsible shareholders. Another way to promote sustainable investments could therefore be to define and implement a European label regarding Environmental Social and Corporate Governance (ESG) good practices.

Finally, investors could better be encouraged to retain assets on a long term basis through several incentives: extra voting rights, extra shares (as implemented by LLoyd, Air Liquide, etc.), extra dividends (as implemented by L’Oreal), etc.

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Concluding, the EU should set a special agenda including:

- a better adapted regulatory system and banking regulation for long-term investment,
- a strengthened role for long-term European institutional investors and development banks,
- The creation of new long-term instruments for financing European projects with a long term commercial potential.infrastructure.

In clear terms, without substantial changes in prudential, accounting and tax regulations, the objectives set in the EU 2020 Strategy and in the Mario Monti report on “A new strategy for the internal market” will not be reached. An appropriate new European framework for long-term investments and/or investors will make a substantial contribution to the promotion of long-term public policies needed to foster a sustainable growth.