Working paper

A specific treatment is required for long-term investment

Long-term investments definition may cover a very wide range of economic needs - infrastructures, housing, transport, communications, new energies, etc. - and represent considerable financial sums. In addition, government borrowing points in many cases to growing use of private financing.

The discrepancy that seems to exist between supply and demand for long-term investment could stem from multiple and complementary shortcomings or obstacles relating to tax incentives, the structure and legibility of the vehicles offered for investors' capital, or the conditions for providing a genuine political guarantee for the long-term viability and profitability of the investments made. These factors for success are still to be analysed; at this stage, Eurofi's work has focused on the prudential and accounting framework for financial intermediaries. Indeed, the undifferentiated treatment of financial assets, whatever their management horizon, particularly from an accounting and prudential perspective, already seems to be standing in the way of long-term investment. These situations can be seen whatever the nature of the institution carrying them: insurance firms, banks, pension funds, sovereign funds or hedge funds.

This situation is reflected in financial communications that are not particularly legible, with the mark to market approach and the contingencies affecting the value of investments over the short term having repercussions on the financial statements, although the actual horizon for these investments is different. In light of this upheaval, certain investors traditionally wishing for the long term e.g. insurance companies… are adopting behaviours that go against their actual purpose, which is to ensure a stable financial presence within businesses or infrastructure projects, secure consumers' savings and safeguard their purchasing power...A genuinely specific accounting and prudential framework appears to be necessary for long-term investments.

I. Investors and issuers are calling for long-term investment vehicles

Certain issuers need to have investors who can accompany them over time. The parties in charge of economic activities with cycles that are long (motor industry, steel industry) or very long (airport or port infrastructures, nuclear power, etc.) are looking for investors who can notably participate in financing with a timeframe that is consistent with that for their investments, commit throughout the project development phase, effectively understand the nature of the operation's risk and adjust their financial support throughout the project. This type of need is particularly pressing, at a time when we are faced with numerous challenges, including the development and harnessing of renewable energies or the provision of urban and transport infrastructures; particularly since government borrowing points in many cases to growing use of private financing.

Certain financial institution liabilities require investment vehicles that follow the development of the economy and wages. This is notably the case for pension funds. Indeed, they need to invest over the long term, in real assets such as equities or property, in order to replicate the trend for wages which, as for equities, is linked to global economic performance[1].

[1] *"Insofar as wages or company profits represent payment for production factors within the economy, and they are a stable part of value added, all it takes is for their values to be stable and move within a range over the long term for there to also be a stable relationship between wages and equity prices. Indeed, wages and equities are effectively co-integrated, in other words they show a high level of dependence over the long term".* "Impact of Regulations on the ALM of European Pension Funds January 2009 - EDHEC Risk and Asset Management Research Centre Publication"

With long-term investments, investors are looking for opportunities for diversification, particularly in terms of their horizon. These investors notably turn to dedicated infrastructure financing funds. Research by CEPRES[2] highlights the importance of the mass of capital raised, put at 67 billion dollars for 2007.

II. Supply and demand for long-term investment do not always seem to match up. To identify the areas for progress, it is necessary to analyse the regulation of intermediaries, the incentives for investors and the quality of visibility available on long-term risks

Tax incentives encouraging precautionary savings should also promote long-term investment. However, the investment vehicles chosen at this time by savers do not necessarily reflect this focus. Some of these vehicles invest in bond assets, while the tax incentives for holding equities (such as PEA share-based savings schemes in France) are sometimes used on vehicles with high asset turnover rates.

Research on **dedicated infrastructure funds** shows that while these funds have developed in response to investors looking for long-term investments with relatively stable and predictable cash flows, they **do not have any specific risk, return on investment or yield characteristics**.

The discrepancy that seems to exist between supply and demand for long-term investment could stem from shortcomings or obstacles that encourage **three complementary areas for action** to be explored.

- The area for **incentives for long-term investment**, including tax incentives and the structure and legibility of the vehicles offered for capital (savings accounts, funds, etc.), etc.
- The area for **factors improving visibility for private investors** on long-term investments, notably finding a way to provide them with a **political guarantee for a certain long-term viability and profitability on the investments made**.
- Lastly, the area for **prudential and accounting regulations** governing the financial intermediaries. Those that are in charge of liaising between “primary” investors and project owners and issuers.

At this stage, this document only addresses this last area.

III. The short-term contingencies brought about by prudential or accounting regulations are putting investors in a difficult position, undermining long-term investment, and may produce distortions of competition and lead industrial players to transfer risks to consumers

First of all, we can see a "disinvestment" from the equities market, which is detrimental to financing for businesses. In November 2008[3], P. Artus reported on the dwindling appetite for equities among investors since 2001. At the same time, he demonstrated that this growing aversion was undermining performance levels on equities[4] and, in the end, the financing capacity of businesses.

---

2 Buchner, A., C. Kaserer and D. Schmidt (2008), “Infrastructure private equity: markets, funds, investment behaviour and outlook”, Center of Private Equity Research (CEPRES), Munich.

3 P. Artus Natixis Special Report No. 139, November 2009

4 *"PERs in the US and Europe are poorly explained by their usual determinants (inflation or interest rate, cyclical position, scale of the equities risk). The fact that they have been trending down since 2002 stems from the attitude of institutional investors, which had a*

We are also seeing competitive distortions between the different investment vehicles. During a period of **economic growth** and low rates, immediate and higher attractive yields encourage investors and **savers to prefer investment vehicles with the least prudential constraints**. During a period of **cycle reversal**, it is **all vehicles based on equities, which are penalised**. This transfer to "safer" investments can be seen independently from expected cash flow levels and despite the limited yield on money market vehicles. Since this distortion of competition stems from the inability of subscribers to effectively understand the risk associated with their investments.

In the end, current regulations seem to be leading to transfers of risks to consumers and citizens and a possible erosion of purchasing power on their savings. Many pension funds, incapable of coping with the consequences of the short-term volatility of their performances, imposed by their regulations, have moved away from[5] the provision of defined benefit funds[6] and are now only offering defined contribution policies.
However, with this type of product, employees cannot anticipate how much their pension will be when they retire. What is more, these products transfer the immediate market risks over to them. Lastly, regulations by leading funds to invest on fixed income products that may sometimes even be very short, implicitly lead funds' subscribers accepting a deindexation of their investments in relation to economic developments. This deindexation raises concerns of erosion in purchasing power in relation to wage trends.

Set against this backdrop, over pension funds and public long term investors, many financial institutions are calling for the horizon for holding assets to be taken into consideration on a prudential and accounting level, and they are starting to be heard. For example, Solvency II highlighted the need to reduce insurers' regulatory impacts related to the one-year volatility of assets booked against long liabilities. At this time, the European legislator also found that a prudential treatment based on market prices results in damaging pro-cyclicalities for insurers.

For its part, in April 2009, the G20 set out the need to improve the conditions for valuing financial instruments, more specifically factoring in the horizon over which they are held. Within this context, the FASB has agreed to adapt the approach for valuing assets held to maturity, now based not on their market value, but their historical cost and their effective credit risk.

IV. Long term investors have also to face up some of the failings with prudential and accounting regulations identified during the financial crisis

These failings can be summed up based on four areas:

1. Too exclusive an approach for only factoring in market risks when valuing assets, to the detriment of the counterparty risk or the asset holder's specific liquidity constraints.
2. Assessments of asset values and risks based too exclusively on past data (statistics).
3. Assessment of the value of assets by all investors based on parameters that are too standardised, threatening systemic liquidity;
4. Holding of equities considered too exclusively as a trading exercise.

---

strong appetite for equities up until 2001, but which have shown a strong aversion to the equities risk since 2002.
The fall in the valuation of equities is therefore not due to a change in the economy, but rather a change in the attitude among institutional investors in relation to equities". P. Artus Natixis Special Report No. 139, November 2009

5 "Impact of Regulations on the ALM of European Pension Funds January 2009 - EDHEC Risk and Asset Management Research Centre Publication"

6 Contrary to "defined contributions" funds, "defined benefits" funds commit to the amounts of pensions to be paid

V. **Long-term investment represents an investment looking to "stick to" economic trends and benefiting from strong value added from the intermediary, notably for understanding long-term economic trends and ensuring the effective management of risks inherent to the investment horizon**

In order to be able to identify the concrete provisions likely to encourage long-term investment, it must be possible to define what long-term investment actually represents. This is not easy since the investment vehicles, their maturities, the management techniques implemented and the origins of the liabilities, etc. are too diversified.

However, this concept can notably be determined by the specific characteristics of the objective for long-term investors: namely enabling savers to benefit from savings that do not lose their purchasing power over a long horizon compared with wages. In view of this objective, we can consider that this represents an investment:

- Seeking to "stick to" trends for economies or economic sectors
- Benefiting from strong value added from the intermediary, particularly in terms of understanding long-term economic trends (business sectors, etc.) and the effective management of risks inherent to the investment horizon and duration
- Often based on equities

The definition put forward makes it possible to avoid building regulations around discretionary temporal thresholds. Neither does it introduce any constraints concerning the management techniques implemented. It therefore allows regulations to remain open to innovation. Lastly, this definition makes it possible to take into consideration equities and perpetual securities in general.

Such a definition enables the banking concept of the “banking book” to be extended for investors in the broadest sense. It provides a basis for the accountant and supervisor for determining the nature of management practices. More specifically, it makes it possible to identify whether an asset purchase or sale is part of a trading approach - the aim of which is to benefit from market movements - or represents an investment management action - the reference for which is the asset's economic development and its suitability in relation to the management objectives required by the nature and structure of the intermediary's liabilities.

VI. **Moving towards a specific accounting and prudential framework for long-term investments**

It seems to be worth trying to identify what is otherwise likely to encourage – and at least not block – long-term investment and what concerns prudential and accounting regulatory aspects for financial intermediaries. Such a long-term prudential and accounting framework could be built around three principles:

- **Developing long-term decision-making, valuations and information:**

- Making long-term ratings available in addition to existing ratings;
- For the valuation of assets, systematically implementing economic models (specifications for economic development assumptions and likely cash flow forecasts), in addition to purely statistical models and market values;
- Defining horizons based on both the various economic sectors for investment and the liability constraints of investors;
- Decisions by long-term investors to buy and sell assets must only be based on their economic performance forecasts at maturity for the corresponding liabilities, and not market trends and opportunities.

- **For long-term investment activities, replacing the one-year solvency concept with the concept of "solvency at maturity"**
- **Making it possible for prudential and accounting rules to reflect asset-liability management decisions and risk hedging policies**