

# Fostering Long-term Investment and Economic Growth: A Long-term Investor's View

by

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*Active long-term investors are needed for well-functioning financial markets. Long-term investors are also essential for economic growth, as they finance infrastructure and are more likely to become engaged as active shareholders. Since long-term investments are likely to provide higher returns for pensions and long-term savings, they should be able to attract capital from pensions and other long-term savings funds, which are ample due to high savings rates in Europe. But long-term investment should also be encouraged via the regulatory framework and through fiscal incentives. Furthermore, the development of innovative financial instruments will be necessary to foster long-term investment. Finally, cooperation among long-term investors should also help to develop a new “investment culture”.*

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## I. The equilibrium of financial markets requires active, long-term investors

### *Long-term investment through well-functioning financial markets*

As CFO of the Caisse des Dépôts<sup>1</sup> (after being CIO of CNP Assurances<sup>2</sup>), I do obviously believe in the specific and macroeconomic advantages of long-term investment.

Long-term investment should not be opposed; rather, it should be seen as contributing to the smooth functioning of financial markets. The excessive volatility we have seen in the markets – and in some circumstances, the lack of liquidity – are largely due to the short-term, herd-like behaviour of most investors. Well-functioning financial markets need investors with different views about the actual value of the assets being traded, which requires, to a large extent, that investors also have *different time horizons*. Investors with a long-term horizon consider the intrinsic value of assets, rather than next weeks' market tendency, and are the most likely to act in a counter cyclical way. Therefore, financial markets, often described as short-term oriented, also need long-term investors to be able to arrive at the most appropriate pricing for listed assets.

Up until a few years ago, for instance, when a sharp decrease in equity markets occurred, it was commonly acknowledged that insurance companies would likely step in to buy equities and keep them on their balance sheets, with a view toward long-term returns. Unfortunately, this is no longer the case.

## II. Long-term investments are essential for economic growth

### 1. Long-term investment is needed to finance infrastructure projects

#### *Europe's infrastructure financing needs are substantial*

To address such global issues as climate change, the scarcity of resources, urbanisation and demographic growth, there will be a huge need for long-term investment. For example, Europe's infrastructure financing needs for transport, energy and the fight against climate change are estimated to be more than EUR 2 000 billion by 2020.

### 2. Long-term investors are more likely to be responsible investors

#### *Focus should be on sustainable, long-term growth*

Only long-term shareholders are likely to become active shareholders, establishing an ongoing dialogue with the management of the listed companies and promoting best practices in terms of governance, environment, and human resources. In general, long-term shareholders tend to focus on sustainable growth rather than on boosting the share price through financial leverage.

### 3. Long-term investments are likely to provide higher returns for pensions and long-term savings

#### *High real returns from long-term investing*

Interest rates are low in real terms, and inflationary pressures are building up in many areas. At the same time, aging populations in Europe and many other developed economies mean that a higher percentage of the population will be

relying on retirement income and savings. Substantial returns for long-term savings and for pension schemes will therefore be required, and this presupposes investment in riskier assets with good long-term prospects.

### III. Long-term savings and resources are relatively abundant in Europe

#### *Savings rates in Europe are high*

In general, Europe has relatively high saving rates. In France, for example, the saving rate is 16% of net available income. The main savings vehicle is life insurance policies (EUR 1400 bn), whose average maturity is 10 to 12 years. Even when policyholders have early redemption options, stability prevails and redemption rates tend to be low. The pension fund industry, another source of long-term savings, has even longer investment horizons. France also has specific long-term investors like the *Caisse des Dépôts*, which manages public savings deposits (“*Livret A*”); and legal deposits (private funds protected by law). The role of the financial institutions that gather and manage these various types of savings should be to invest long.

#### *But various constraints decrease investors' capacity for long-term investing*

However, according to a recent report (by Oliver Wyman) presented at the Davos Forum, the capacity of major investors to use their assets for long-term investing is dramatically decreasing. In 2009, long-term institutional investors controlled close to half of the world's professionally managed assets – around USD 27 trillion, out of USD 65 trillion. Various constraints on these investors have resulted in them dedicating only 25% of their total assets – USD 6.5 trillion – to long-term investing.

### IV. The regulatory framework should specifically address long-term investment

#### *Mark-to-market accounting and prudential rules reduce investors' ability to acquire long-term assets*

A combination of mark-to-market accounting and prudential rules which are based on mark-to-market valuations (Solvency II), reduces the ability of investors to endure market volatility, something that is required if they are to invest in assets for the long term. In addition, current rules and regulations imply pro-cyclical behaviour: in periods of market stress, when asset prices are falling, the easiest way for investors to maintain or restore solvency ratios is to sell assets considered risky, often ones with long investment horizons.

The accounting and prudential framework should take into account the particular characteristics of long-term investments; this is already the case when it comes to long-dated government bonds, which benefit from “hold to maturity” accounting and very low capital requirements. Such specific treatment should also apply to investors with stable, long-term liabilities seeking to invest in high-quality infrastructure projects or equities.

### V. It is also necessary to develop innovative financial instruments

#### *The launching of project bonds*

The issuance of **project bonds** is an example of a specific new financial instrument that would enable markets to play their role more effectively. Since the financial crisis, bank loans have generally become shorter in duration, and the financing of infrastructure projects has become more difficult. Through project bonds, the EU Commission would provide EU support to companies that are

issuing bonds to finance major long-term infrastructure projects. The Commission's key role would be to share risk with the EIB and other financial partners, such as long-term investors, by providing guarantees or loans in support of such bonds. Project bonds would require a specific European guarantee, however, to incentivise long-term investors to commit capital.

### *Adoption of fiscal incentives*

Also needed are **fiscal incentives** to attract domestic and foreign savings. Significant tax incentives would help to attract capital that is currently in domestic and foreign, especially emerging, economies' savings funds to long-term financial instruments. In this context, the US "Build America Bonds" initiative is instructive, with strong fiscal incentives for attracting domestic and foreign savings for the financing of infrastructure, energy, as well as social and urban initiatives.

Equalising the fiscal incentives for issuing debt versus equity may be an approach that Europe can take on as well. Indeed, most tax systems favour debt financing over equity, since interest is deductible against corporate profits, but dividends are taxed. As a consequence, this lowers the after-tax cost of debt-financing compared with equity-financing.

## **VI. Concluding remark: co-operation among long-term investors is key**

### *Investors should share their experiences*

Cooperation among the different categories of long-term investors should be encouraged; investors must communicate with each other, understand their similarities, learn from their respective experiences and work towards stronger partnerships.

### *Cooperation is the aim of the Long-Term Investors' Club*

Cooperation is the aim of the Long-Term Investors' Club set up in 2009 by KfW, *Cassa Depositi e Prestiti* and EIB. This Club now comprises 1,424 financial institutions representing the world's most important economic regions, with a balance sheet of USD 3 trillion. The Long-Term Investors' Club allowed the implementation of partnerships in long-term investment projects, such as the Marguerite and the InfraMed Funds dedicated to infrastructure development in the EU and in the Mediterranean Basin. The Club will shortly be expanding to include other leading emerging countries, such as India and Brazil. Cooperation between the Long-Term Investors' Club and the OECD is crucial for a better understanding of the needs of long-term investors and the development of a new "investment culture".

## *Notes*

1. *Caisse des Dépôts* is a state-owned financial institution in France, which manages savings and legal deposits and has a total balance sheet of €270 bn.
2. *CNP Assurances* is the leading life insurance company in France, with €250 bn under management.