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OECD DISCUSSION NOTE

**PROMOTING LONGER-TERM INVESTMENT BY INSTITUTIONAL INVESTORS:
SELECTED ISSUES AND POLICIES ***

This note has been drafted for the Eurofi high-level seminar on the benefits and challenges of a long term perspective in financial activities, to be held in Paris on 17 February 2011.

The note is designed to stimulate discussion on the benefits of long-term investing to growth, sustainable development and financial stability, and the barriers which may be preventing institutional investors from acting over such a time frame.

Drawing on existing OECD work and guidelines, the note also puts forward some initial policy suggestions for encouraging long-term investing. Further in-depth analysis and data collection will be undertaken by the OECD in the framework of its current programme of work



* The paper is issued under the responsibility of the OECD Secretary General. It does not necessarily reflect the opinion of OECD members. Comments are welcome.

EXECUTIVE SUMMARY

1. The main institutional investors in the OECD, pension funds, insurance companies and mutual funds, held over US\$65 trillion at the end of 2009. Emerging economies generally face an even greater opportunity to develop their institutional investors sectors as, with few exceptions, their financial systems are largely bank-based. The main institutional investors in these countries are Sovereign Wealth Funds, which held over US\$4 trillion at the end of 2009.

2. The growing clout of institutional investors has brought a transformational change in financial systems. Traditionally, these investors – and, in particular, pension funds, life insurers and mutual funds that operate in retirement savings systems - have been seen as sources of long-term capital with investment portfolios built around the two main asset classes (bonds and equities) and an investment horizon tied to the often long-term nature of their liabilities. Institutional investors also reduce reliance on the banking system, acting as shock absorbers at times of financial distress. The growth of these institutions has also contributed to the development of capital markets, providing financing to companies and governments and helping to develop mechanisms for corporate control and risk management.

3. Despite this generally rosy picture, these supposedly long-term institutional investors are also recurrently being labelled as “short-termist”. Signs of such growing short-termism include the fact that investment holding periods are declining and that allocations to less liquid, long-term assets such as infrastructure and venture capital are generally very low and are being overtaken in importance by allocations to hedge funds and other high frequency traders. Other related concerns over the behaviour of institutional investors are their herd-like mentality which may sometimes feed asset price bubbles and their tendency to being “asleep at the wheel”, failing to exercise a voice in corporate governance.

4. These concerns have led to calls for more “responsible” and longer-term investment among institutional investors, in particular pension funds, life insurers and mutual funds that operate in retirement savings arrangements. Such investment would share the following features and benefits:

- ***More patient capital that acts in a counter-cyclical manner.*** Given their long-term liabilities, institutional investors should in principle be concerned with long-term investment performance, providing and monitoring investment mandates that reflect such an investment horizon and holding to their shares for long periods. They should also act in a counter-cyclical manner, continuing to invest in riskier assets and even seeking new investment opportunities at times of market weakness. By the same token, they should normally rebalance their portfolios when asset price bubbles develop, reducing exposure to such asset classes. Through such investment strategies institutional investors can promote financial stability, helping to correct speculative excesses and providing a buffer during a financial crisis.
- ***An ongoing, direct engagement as shareholders and consideration of environmental and other longer-term risks in investment and risk management strategies.*** Acting as responsible asset owners would ensure a better monitoring of company management, aligning the company managers’ incentives with the longer term interests of the company, and reducing the scope for corporate malfeasance and excessive leverage and other forms of unwarranted risk exposure among corporations. Responsible investors should also ensure that they understand and integrate appropriately environmental risks, such as climate change, in their investment and risk management strategies, promoting long-term risk management in the companies that they invest in.
- ***A more active role in the financing of long-term, productive activities that support sustainable growth, such as cleaner energy, infrastructure projects, and venture capital.*** Such investments can drive competitiveness and support economic growth by increasing private and public sector productivity, reducing business costs, diversifying means of production and creating jobs. While investment in listed

equities and corporate bonds already achieves some of this goal, unlisted, long-term investments such as infrastructure can avoid some of the pitfalls of the short-termism prevalent in public markets.

5. Moving from the current mindset to a longer-term investment environment requires a transformational change in investor behaviour, that is, a new “*investment culture*”. The market, by its nature, is unlikely to deliver such a change. Hence, major policy initiatives in a variety of areas are needed. The report highlights the following:

- i. ***Reforming the regulatory framework for institutional investors:*** policymakers need to promote greater professionalism and expertise in the governance of institutional investors. Collaboration and resource pooling can also be encouraged in order to create institutions of sufficient scale that can implement a broader investment strategy and more effective risk management systems that take into account long-term risks. Regulators also need to address the bias for pro-cyclicality and short-term risk management goals in solvency and funding regulations, and relax quantitative investment restrictions to allow institutional investors to invest in less liquid, long-term assets.
- ii. ***Encouraging institutional investors to be active shareholders:*** policymakers should remove regulatory barriers to allow institutional investors to engage in active share ownership. They can also reduce the burden of active engagement (particularly for smaller investors) by encouraging collaboration via investor groups and can support national or international codes of good practice and issue guidance themselves of how they expect institutional investors to behave. In order to ‘nudge’ investors to follow such guidance, supervisors can shift the focus on their investigations, enquiring as to the turnover of funds, the length of mandates given to external managers, how fees are structured, and voting behaviour.
- iii. ***Designing policy frameworks that are supportive of long-term investing:*** the general investment policy environment for long-term investments often lacks transparency and stability. Government support, such as long-term policy planning, tax incentives and risk transfer mechanisms may be required to engage investors in less liquid, long term investments such as infrastructure and venture capital.
- iv. ***Addressing knowledge gaps and behavioural biases:*** retail investors need support to help them meet their long-term investment goals. Regulators should also become better acquainted with long-term risks and new financial instruments. In order to achieve these objectives, governments and other stakeholders should support information collection, public awareness and financial education campaigns that promote long-term investment and risk management.

I. Benefits of long-term institutional investors

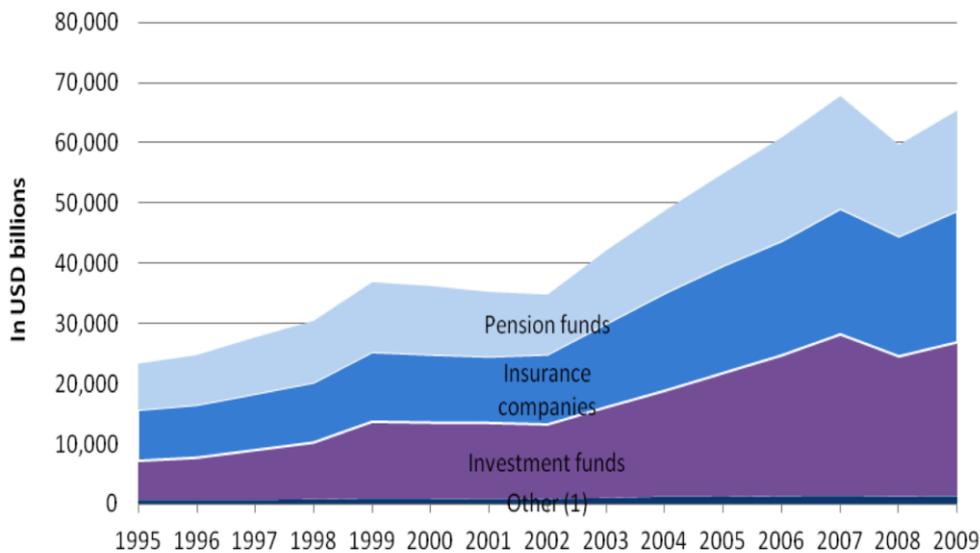
The expansion of institutional investors is set to continue

6. The main institutional investors in the OECD, pension funds, insurance companies and mutual funds, held over US\$65 trillion at the end of 2009 (see Figure 1).¹ Despite the recent financial crisis, the prospect for future growth is unabated, especially in countries where private pensions and insurance markets are still small in relation to the size of their economies. Emerging economies generally face an even greater opportunity to develop their institutional investors sectors as, with few exceptions, their financial systems are largely bank-based. The main institutional investors in these countries are Sovereign Wealth Funds,

¹ The broader class of institutional investors include other entities such as public investment funds, Sovereign Wealth Funds, endowments and foundations, hedge funds and private equity funds. Hedge funds and private equity funds also act as investment vehicles for other types of institutional investors.

which held over US\$4 trillion at the end of 2009. Whether the growth of pension funds materialises also in these countries will depend on some key policy decisions, such as the establishment of a national pension system with a strong funded component, which is nowadays a common feature in most OECD countries.

Figure 1. Assets held by institutional investors in the OECD area, USD billions, 1995-2009



Source: OECD Institutional Investors Database

Note (1): Other forms of institutional savings include foundations and endowment funds, non-pension fund money managed by banks, private investment partnership and other forms of institutional investors.

Some, like pension funds and life insurers, are in principle natural long-term investors

7. The growing clout of institutional investors has brought a transformational change in financial systems. Traditionally, these investors – and, in particular, pension funds, life insurers and mutual funds that operate in retirement savings systems - have been seen as sources of long-term capital with investment portfolios built around the two main asset classes (bonds and equities) and an investment horizon tied to the often long-term nature of their liabilities. The exemplary case are pension funds, which start collecting contributions when individuals enter the workforce and only start paying benefits with the assets accumulated thirty to forty years later. Furthermore, increasing longevity has increased the period over which payments need to be paid, further increasing the duration of pension fund liabilities. Life insurers also tend to have long-term liabilities, especially major providers of annuities and similar retirement products. The corresponding long-term investment horizon in principle allows such investors to take advantage of any ‘illiquidity’ premium which long-term investments such as infrastructure and venture capital should deliver. Holding investments over the longer term can also reduce turnover within portfolios and thereby costs; this being an important consideration for pension funds since a 1% charge over 40 years can reduce eventual pension income by around 20%.

Their growth has contributed to capital market development

8. Institutional investors also reduce reliance on the banking system, acting as shock absorbers at times of financial distress. The growth of these institutions has also contributed to the development of capital markets, providing financing to companies and governments and helping to develop mechanisms for corporate control and risk management. At the same time, individual investors have been able to pool their savings in products where investment risks can be diversified and insurance products that protect them from a variety of life related and property risks.²

Yet, they are often labelled as short-termist

9. Despite this generally rosy picture, these supposedly long-term institutional investors are also recurrently being labelled as “short-termist”, of feeding asset price bubbles with a herd-like mentality and of being “asleep at the wheel” as company managers abuse their power to the detriment of shareholders. One key feature of institutional investors – especially the smaller ones - is that they rely on asset management firms for a large part of their investments. Such a trend has been intensified in recent years with the move to increase exposure to so-called alternative investments, such as hedge funds and private equity funds. Control over external asset managers is often focused on short-term performance monitoring, leaving day-to-day investment decisions in the hands of professionals who may not always have the best interest of the ultimate asset owners in mind.

Long-term investing involves...

10. These concerns have led to calls for more “responsible” and longer-term investment among institutional investors, in particular pension funds, life insurers and mutual funds that operate in retirement savings arrangements. Such investment would share the following features and benefits, which are described in detail in Section II:

...patient capital

- *More patient capital that acts in a counter-cyclical manner.* Given their long-term liabilities, institutional investors should in principle be concerned with long-term investment performance, providing and monitoring investment mandates that reflect such an investment horizon and holding to their shares for long periods. They should also act in a counter-cyclical manner, continuing to invest in riskier assets and even seeking new investment opportunities at times of market weakness. By the same token, they should normally rebalance their portfolios when asset price bubbles develop, reducing exposure to such asset classes. Through such investment strategies institutional investors can promote financial stability, helping to correct speculative excesses and providing a buffer during a financial crisis.

...active shareholding

- *An ongoing, direct engagement as shareholders and consideration of environmental and other longer-term risks in investment and risk management strategies.* Acting as responsible asset owners would ensure a better monitoring of company management, aligning the company managers’ incentives with the longer term interests of the company, and reducing the scope for corporate malfeasance and excessive leverage and other forms of unwarranted risk exposure among

² For a more detailed discussion of the benefits of long-term investing see “*The Future of Long-term Investing*”, World Economic Forum, 2011.

corporations. Responsible investors should also ensure that they understand and integrate appropriately environmental risks, such as climate change, in their investment and risk management strategies, promoting long-term risk management in the companies that they invest in.

...and investments in infrastructure and new ventures

- *A more active role in the financing of long-term, productive activities that support sustainable growth, such as cleaner energy, infrastructure projects, and venture capital.* Such investments can drive competitiveness and support economic growth by increasing private and public sector productivity, reducing business costs, diversifying means of production and creating jobs. While investment in listed equities and corporate bonds already achieves some of this goal, unlisted, long-term investments in infrastructure, low carbon projects and venture capital can avoid some of the pitfalls of the short-termism prevalent in public markets.

A transformational change in investor behaviour is needed

11. Moving from the current mindset to a longer-term investment environment requires a transformational change in investor behaviour, i.e a new “investment culture”. The market, by its nature, is unlikely to deliver such a change. Hence, major policy initiatives, in a variety of areas are needed. Some of these initiatives are considered in Section III of this report.

II. Barriers to institutional investors acting over the long-term

a) The investment management process

The strategic asset allocation underpins long-term investment

12. Institutional investors generally rely on a strategic investment allocation that ensures regular flows to different asset classes and hence a certain stability in the allocation of capital. From a performance perspective, the strategic allocation is the most important decision for investors and needs to be reviewed regularly, usually once a year. Changes in the strategic allocation, however, will normally be less frequent than that. Some investors also engage in ongoing, short-term departures from such allocations, making so-called tactical bets, in order to attempt to benefit from what are perceived as mispricing of assets relative to fundamentals. Such differences in investment activity also apply at the level of individual securities, with one passive strategy involving index-tracking and the other – active – involving security selection and market timing.

Yet asset management is increasingly polarised into hyperactive and excessively passive investors

13. Following the crisis, many institutional investors have become dissatisfied with the traditional, strategic approach to investing – which tends to have involved closet ‘index’ investing but with ‘active’ management charges. This explains the growing interest in hedge funds, which by construction rely on tactical, active investment management to try to deliver genuine ‘alpha’ returns, or performance over and above an index. At the same time, investors are making greater use of passive investment for the more traditional parts of their portfolios, capturing market index returns at low cost. In their current form, neither style is conducive to long-term, active, responsible share ownership on the part of institutional investors.

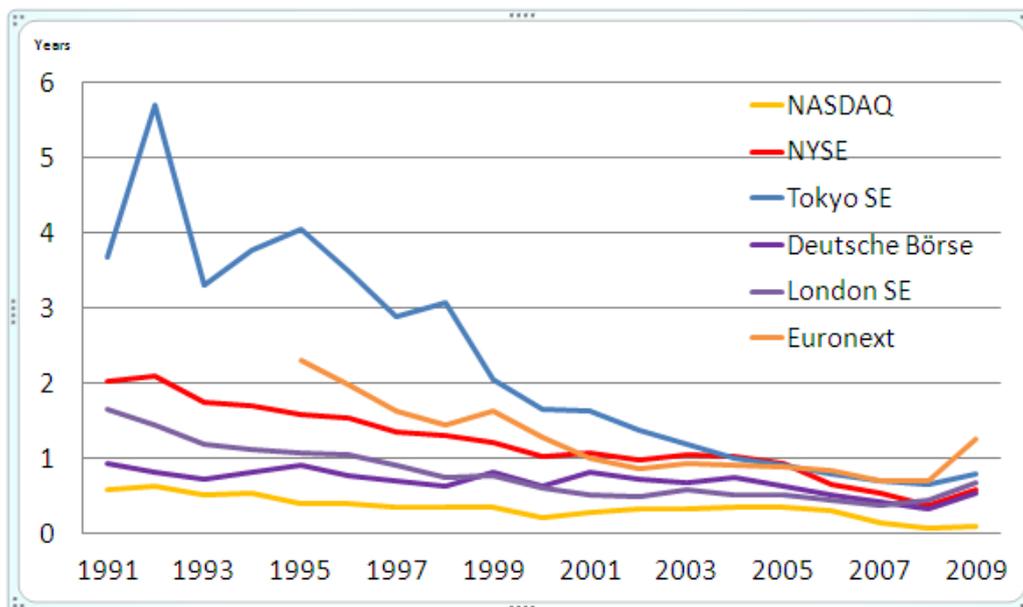
Short-termism is evident in declining holding periods...

14. One result of this trend is the declining investment holding period observed in the last few decades in most OECD stock markets, which has gone hand in hand with the growing market presence of institutional investors.³ As shown in Figure 2, the average holding period has fallen between one and three years in selected OECD stock exchanges over the last twenty years. Looking further back, the drop is even greater. For instance, in the 1980s, the average holding period in the New York stock exchange was over 5 years, compared to 5 months today.

---which even affects pension funds

15. While such trend is partly accounted by the growing role of some niche investors, such as hedge funds, there is evidence that even supposedly long-term investors such as pension funds end up having portfolio turnover much greater than originally intended.⁴ Furthermore, pension funds are gradually becoming the most important investors in hedge funds, so they also contribute indirectly to the rapid increase in the frequency of trading observed in recent years.

Figure 2. Average Holding Period - Selected Exchanges



Source: OECD (report DAF/CA/CG(2010)12)

Agency problems

16. There is a variety of reasons for this growing short-termism in

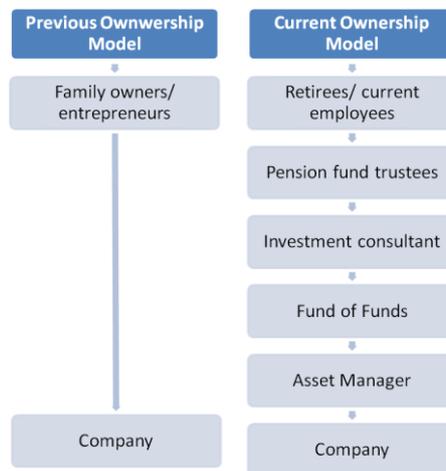
³ The 2004 review of the OECD Principles of Corporate Governance reflect the fact that institutional shareholders – pension funds, insurance companies, mutual funds, hedge funds, and other collective investment schemes – were often the dominant investors in OECD markets. Individuals held less than one fifth of shares in most markets, the main exception being the United States. Even there, direct individual ownership fell from 60% of the market to 40% between 1991-2009.

⁴ See for example, the report “Investment Horizons – Do Managers Do What they Say”, by the IIRC Institute and Mercer, which shows that active, long only equity managers in various countries had portfolio turnover rates that exceeded 150-200 percent the expected level during 2006-9. The full study can be downloaded at http://www.iircinstitute.org/pdf/IIRCMercerInvestmentHorizonsReport_Feb2010.pdf.

are part of the cause of short-termism

investment management. For insurers, increasing competition, demutualisation and the consequent investor pressure are key factors leading them to focus on short-term profitability and investment returns. For pension funds, the cause is primarily an agency problem.⁵ Because of their lack of in-house expertise, most pension funds - the main exceptions being some of the larger ones - rely on external asset managers and consultants for much of their investment activity. However, poorly governed institutions do not make good monitors of third parties. Pension funds may therefore be failing to direct and oversee external managers effectively and look after the long-term interests of their beneficiaries. A stylised representation of the investment management process is shown in Figure 3, which compares the traditional asset ownership model of capitalism based around family ownership and entrepreneurs with the modern version with a myriad of management layers each involving some form of delegation and hence of potential agency problems.

Figure 3. Asset ownership and management models



Source: Governance for Owners⁶

Performance evaluations and mandates are generally short-term based

17. External asset managers generally have mandates not extending three years and ongoing performance evaluations. In-house managers at pension funds and other institutional investors also have performance-based remuneration that is often based on short time periods. As a result there is pressure to take short-term risks in order to beat market benchmarks and peers. If such bets pay off, managers may be rewarded with extensions of their mandates and higher remuneration.⁷

⁵ For a detailed analysis of short-termism focusing on the experience of the United Kingdom see Paul Myners' "Review of Institutional Investment", 2000, or the Marathon Club's "Guidance Note on Long-term Investing", 2007 (<http://www.marathonclub.co.uk/Docs/MarathonClubFINALDOC.pdf>).

⁶ <http://blogs.law.harvard.edu/corpgov/2010/07/31/why-stewardship-is-proving-elusive-for-institutional-investors/>

⁷ The International Corporate Governance Network is currently preparing a set of good practices in agreements between asset owners and their fund managers, with the aim of promoting more long-term behaviour in the capital markets and a greater focus on key risks. A call for evidence was launched on 31 January 2011.

Securities lending contributes to short-termism

18. Institutional investors also contribute indirectly to short-termism via some common investment activities, such as securities lending, where the funds' securities are lent to other investors, often hedge funds, who use them to support their trading strategies, sometimes to take bets against those same shares that they have borrowed.⁸ Managers of Exchange Trade Funds (ETFs), products increasingly used by institutional investors for passive investment, also rely on securities lending to achieve low fees. Investors may therefore be inadvertently contributing to speculative trading activities in the very securities that they own.

Insufficient investor oversight over portfolio turnover and costs

19. Compounding this problem, some institutional investors may be dedicating insufficient attention to issues such as portfolio turnover or costs, failing to provide clear guidelines to their managers about the investment horizon and how that fits into the process from the outset. Short-termism is reinforced by behavioural factors, such a general tendency among investors to focus on recent past performance as a proxy for future performance. This well-“recency bias”, which is well-documented in the behavioural finance literature, continues despite the many caveats and warnings in the asset managers' marketing brochures. Given the complexity of investing, the uncertainty over the future, and the difficulty in discerning useful information from noise, investors often rely on such heuristics or rules of thumb for their investment decisions.

Regulations may have intensified the short-term bias

20. Regulations sometimes also exacerbate the focus on short-term performance, especially when assets and liabilities are valued referencing market prices. As an example, the use of market prices for calculating pension assets and liabilities (especially the application of spot discount rates) and the implementation of quantitative, risk-based funding requirements appear to have aggravated pro-cyclicality in pension fund investments during the 2008 financial crisis in some countries such as Denmark, Finland and the Netherlands. While in Denmark and Finland regulatory changes were made to avoid fire sales of equities, mortgage bonds and other securities, pension funds in the Netherlands fell into a vicious circle as a result of the use of the spot swap curve to value their liabilities. Their heavy demand for long-term swaps put downward pressure on the long swap rate, which further intensified this demand.⁹

Some solvency regulations may heighten pro-cyclicality in investment strategies

21. The introduction of Solvency II for insurers in the European Union – expected in 2013 - may heighten the procyclical nature of investment strategies among these institutions. Insurers will be called upon to reduce risk when market performance worsens in order to improve their estimated resilience in the solvency test. At the same time, Solvency II will penalise insurers for holding assets with high volatility, such as equity; there is thus expected to be a migration away from equity to fixed-income assets, which will lower overall

⁸ In the practice known as short-selling, an institution sells a security it does not own, but usually enters into an agreement to borrow it (via securities lending) in order to settle the trade at maturity. Naked short selling, or naked shorting, is the practice of short-selling a financial instrument without first borrowing the security or ensuring that the security can be borrowed.

⁹ Severinson, C. and Yermo, J. (2010), “*The Impact of the Financial Crisis on Defined Benefit Plans and the Need for Counter-Cyclical Funding Regulations*”, OECD Working Papers on Finance, Insurance and Private Pensions, No. 3, OECD Publishing. doi: 10.1787/5km91p3jszxw-en Special Report of the Geneva Association Systemic Risk Working Group (March 2010), —Systemic Risk in Insurance: An Analysis of Insurance and Financial Stability, the Geneva Association, page 39.

portfolio variability. While this may serve to reduce the magnitude of procyclicality effects, it is also likely to lead to lower exposure to less liquid, long-term assets.

b) Lack of corporate engagement and the management of long-term risks

Institutional investors are critical players in corporate governance

22. The 2004 revision of the *OECD Principles of Corporate Governance*¹⁰ outline the importance of institutional investors as active shareholders:

“The effectiveness and credibility of the entire corporate governance system and company oversight will, therefore, to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest.”

The OECD Principles of Corporate Governance call for active ownership

23. While the OECD Principles “do not seek to prescribe the optimal degree of investor activism,” they nevertheless suggest that many investors are likely to conclude in considering the costs and benefits of exercising their ownership rights that positive financial returns and growth can be obtained by undertaking a reasonable amount of analysis and by using their rights (Principle II.F).¹¹

24. Given institutional shareholders are now the main owners of shares in many equity markets, with pension funds playing a major role, this oversight role is increasingly important. Hence, in the wake of the economic and financial crisis of 2008/2009, attention has turned to how effective these shareholders were in overseeing the boards of the companies they invest in.

25. Part of the post-mortem on the crisis has focused on the failure of such shareholders – the ultimate overseers of financial firms - to prevent some of the most glaring corporate governance failures (from excessive risk concentration and high leverage to misaligned salary incentives). To quote the Dutch Minister of Finance: “We cannot avoid asking ourselves what you, shareholders, have done to prevent and manage the crisis. Unfortunately, and I know you don’t like to hear this, the answer is almost nothing.”¹² Lord Myners, author of a previous

¹⁰ <http://www.oecd.org/dataoecd/32/18/31557724.pdf>

¹¹ The case for active ownership has also been eloquently outlined by TIAA-CREF, a large US institutional investor: “Simply selling stock in the face of inadequate performance is not the most attractive option. In active as well as passive segments of portfolios, investors should be vigilant in trying to prevent problems before value is lost and it is too late to sell, or increasingly difficult or expensive to address...TIAA-CREF believes that long-term investors who have an effective focus on overseeing their investments will play a vital role in enhancing good corporate governance which in turn will help prevent a recurrence of severe crises in the future.... As providers of capital, long-term investors have among the most to lose if markets deteriorate and asset prices fall....This makes good economic sense in terms of our mission and is part of our job as fiduciaries representing our clients.” Their solutions include allowing shareholders access to corporate proxy material to nominate directors, requiring a majority shareholder vote to elect directors, and an annual shareholder vote on executive compensation. See ‘Responsible Investing and Corporate Governance: Lessons Learnt for Shareholders from the Crisis of the Last Decade’ http://www.responsible-investor.com/uploads/uploads/resources/research/11265308868TIAA-CREF_Governance.pdf

¹² Speech to the ICBN as reported in Global Proxy Watch, Vol XIII, No. 10, March 6 2009.

review of institutional investors and corporate governance in the UK, has voiced similar opinions.¹³

26. The OECD's review of corporate governance and the financial crisis¹⁴ identified the lack of active participation on the part of institutional investors as a key weakness in the global system of corporate governance. The OECD's paper concludes that, aside from some impediments still existing in some markets - such as share blocking, taxation issues etc. - shareholders have been largely passive and reactionary in exercising their rights, in many cases voting in a mechanical manner relying on proxy voting advisers and generally failing to challenge boards in sufficient number to make a difference.

27. A related aspect of engagement is the extent to which institutional investors consider long-term risks in their investment strategies, in particular environmental factors. While there has been much interest in "responsible investment" in recent years by pension funds and other institutional investors, most are far from fully and comprehensively integrating environmental, social and governance (ESG) factors in their investment strategies. At the international level, the drive for responsible investment has been led by organisations such as the OECD with the Guidelines for Multinational Enterprises and the UNEP Finance Initiative, which helped develop the UN Principles for Responsible Investment. The incorporation of ESG factors in investment strategies is supported by the Global Reporting Initiative, which has developed standards for company reporting in this area. Some regulators have introduced requirements for institutional investors to disclose whether ESG risks are considered in the investment strategy, but no regulator has gone as far as actively requiring their integration in risk management strategies. Similarly, risk rating agencies are only slowly waking up to the importance of these risks for companies' financial health.

c) Problems with investment in less liquid, long-term assets

In principle, institutional investors should be natural investors in infrastructure and venture, but allocations are generally low

28. In principle the long-term investment horizon of pension funds and other institutional investors should make them natural investors in less liquid, long-term assets such as infrastructure and venture capital, sectors which have a clear, positive impact on economic development and growth. Pension funds and other institutional investors are active in the venture capital market, particularly in the United States, while in Europe and other regions, institutional investors tend to focus more on later stage financing deals and buy-out funds. Interest in infrastructure as a distinct asset class is more recent, with the most experienced investors in this area (those based in Australia and Canada) starting operations

¹³ "To date, institutional investors have said little about the lessons they have learnt over the last two years. Put simply, they have not produced satisfactory answers to the question: 'what were the owners of these banks doing?' Remember that shareholders approved value-destroying transactions, and remuneration practices that now appear to have been poorly aligned with corporate health and shareholder wealth." Quoted in Responsible Investor article 'Could the wisdom of crowds help investor and regulator madness on governance and ownership?' 17/12/2009 http://www.responsible-investor.com/home/article/wisdom_of_crowds/P0/

¹⁴ OECD (2009), 'Corporate Governance Lessons from the Financial Crisis and Corporate Governance and the Financial Crisis: Key Findings and Main Messages' <http://www.oecd.org/dataoecd/3/10/43056196.pdf>

about ten years ago. This slower take-off of infrastructure as an investment is largely due to the fact that this sector has relied mainly on public sources of financing. However, there is an expectation that future infrastructure investments will rely to a much greater extent on the private sector.

29. The OECD general definition of infrastructure is the system of public works in a country, state or region, including roads, utility lines and public buildings. Infrastructures are not an end in themselves. Rather, they are a means for ensuring the delivery of goods and services that promote prosperity and growth and contribute to quality of life, including the social well-being, health and safety of citizens, and the quality of their environments.¹⁵

30. The OECD report on Infrastructure to 2030 published in 2006/2007, estimated global infrastructure requirements to 2030 to be in the order of US\$ 50 trillion. It is estimated that adapting to and mitigating the effects of climate change over the next 40 years to 2050 will require around USD 45 trillion or around USD 1trillion a year.¹⁶

31. In many countries such levels of investment cannot be financed by the public pursue alone. The impact of the financial crisis exacerbated the situation leading countries with fiscal deficits and high debt levels to announce austerity packages. Also, traditional sources of private capital such as banks have restrained credit growth since the financial crisis and may be further constrained in the coming years when new regulations (Basel III) take effect. The result has been a widespread recognition of a significant infrastructure gap and the need to explore alternatives to traditional provision of assets.

32. Pension funds are increasingly looking at infrastructure to diversify their portfolios. Infrastructure investments are expected to produce predictable, inflation adjusted and stable cash flows over the long term, matching their existing liabilities and reducing their portfolio volatility. Pension funds and other institutional investors are also creating discussion fora and investment partnerships to foster investments in clean energy and climate change mitigation and adaption.¹⁷

33. Despite these apparent links, so far institutional investment in infrastructure has been limited. It has been estimated that less than 1% of pension funds worldwide are invested in infrastructure projects, excluding indirect investment in infrastructure via the equity of listed utility companies and infrastructure companies.¹⁸

¹⁵ *Going for Growth*, OECD, 2009, highlights that investment in physical infrastructure can benefit long-term economic output more than other kinds of physical investment.

¹⁶ See International Energy Agency (IEA) (2008), *Energy Technology Perspectives: Scenarios and Strategies to 2050*. The estimate is that around half the investment will involve replacing conventional technologies with low-carbon alternatives with the remainder being additional investment.

¹⁷ For a review of these initiatives see *“The Role of Pension Funds in Financing Green Growth Initiatives”*, forthcoming OECD report.

¹⁸ See *“Transcontinental Infrastructure needs to 2030/2050: Pension Funds Investment in Infrastructure”*, forthcoming OECD report, Futures Programme.

Some regulations discourage such long-term investments

34. In addition to the standard difficulties of any novel asset class, there are a variety of obstacles impeding greater involvement by institutional investors in the financing of infrastructure and clean energy projects.

- First, the investment regulations of institutional investors sometimes discourage allocations to unlisted instruments, which is often the most efficient and longer-term way to invest in such asset classes.
- Second, investor capability may be thwarted by governance weaknesses and insufficient scale to engage in such investments.
- Third, the general investment policy framework in the country may not be conducive to the development of opportunities in this realm. For instance, public private partnerships in the infrastructure sector have been concentrated in a few countries such as the United Kingdom.

35. Another sector that in principle should appeal to long-term investors is venture capital. The financing of new ventures is an inherently high risk activity, but diversification can be used effectively to improve the risk-return trade-off for institutional investors. Venture capital is an essential source of finance for creating and ensuring economic growth and innovation. Various research studies clearly show how venture capital can transform innovations into broadly-based economic gains and societal benefits. For example, it is estimated that almost 20% of US GDP is generated by companies built by venture capital such as Intel, Apple and Google.

36. Since the crash of the technology bubble, following numerous years of disappointing returns many investors exited the industry leading some to claim that the venture capital model is broken. However, given the total impact venture capital could make on long-term economic growth, governments still consider the development of venture capital as a policy priority.

III. Main policy actions to promote long-term investments

1. Reforming the regulatory framework for institutional investors

37. Regulatory reform can contribute to changing the rules of the game, facilitating a transition to a financial system where institutional investors and the asset management industry on which they depend operate on a longer-term basis:

- *Build the expertise – the investor capability*: informed, knowledgeable investors are the basis for good governance and a proper alignment of incentives. Raising the bar of governance among institutions such as pension funds is essential to create the right incentives among asset managers to better look after the long-term interest of beneficiaries. Investing in less liquid, longer term asset such as infrastructure and venture capital calls for specific skills and appropriate staff in place at all levels – from fund managers to trustees. Although investors often use

specialist consultants, they still require a good understanding of the products in which they invest and an effective system to monitor the strategies and activities of their asset managers. This is even more the case if investors want to follow the direct investment route (or invest in new-build projects). Relevant international guidance in this regard include the *OECD Guidelines for Pension Fund Governance*.

- *Foster collaborative strategies and resource pooling:* small institutional investors are generally at the mercy of consultants and asset managers and have limited capability to control detailed aspects of their asset managers' activities, such as portfolio turnover or securities lending. They are also more likely to use a fund of funds or listed fund route to invest in alternatives, rather than invest directly in unlisted, long-term assets where more effective control over the underlying investment can be exercised. As reflected in the *OECD Core Principles of Corporate Governance* (Principle II.G), regulators can encourage collaboration among institutional investors, outright mergers and other forms of resource pooling in order to create institutions of sufficient scale that can implement a broader investment strategy and more effective risk management systems that take into account long-term risks.
- *Adjust the prudential regulatory framework towards long term investment:* in order to promote and sustain longer term investments, changes in the regulatory framework are needed. Regulators need to address the bias for pro-cyclicality and short-term risk management goals in solvency and funding regulations applied to insurers and pension funds. In countries that still use a quantitative approach to investment regulation, evaluations should be made on a regular basis to allow institutional investors to invest in less liquid assets, such as unlisted infrastructure and venture capital. Regulators should also consider the integration of long-term investment risk factors (in particular, environmental risks) in institutional investors' risk management strategies, as recommended in the *OECD Guidelines for Pension Funds Risk Management*.
- *Create the necessary preconditions for the development of institutional investors:* in some OECD countries and most emerging economies, institutional investors are still relatively underdeveloped. Governments need to establish the appropriate regulatory, supervisory and tax frameworks for such investors to develop. Diversification of wealth holding away from bank deposits will help foster competition and financial innovation. When designing new retirement savings systems or promoting insurance markets, policymakers should also ensure that the initial conditions are set to allow long-term investment to develop.

2. Encouraging institutional investors to be active shareholders

38. Encouraging active share ownership is also a way to foster longer term investment by institutional investors.

- *Regulatory Support:* in order to allow institutional investors to engage in active share ownership governments should first check that there are no regulatory barriers to them doing so (such as share blocking / taxation issues/ takeover issues / rules against collaboration). Practical encouragements could also be put in place (such as allowing electronic voting of shares), or regulation could be more prescriptive (e.g. requiring institution investors to disclose their voting policies and records, as well as their governance and conflict of interest policies, as recommended by the OECD Principles of Corporate Governance).¹⁹ Other incentives, such as giving multiple voting rights to long-term investors, could also be considered.
- *Collaboration and professional services:* the burden of active engagement can be reduced (particularly for smaller investors) by encouraging collaboration via investor groups (such as the International Corporate Governance Network). Alternatively, funds could use activist fund services or proxy voting firms, keeping in mind that their advice should be free from material conflicts of interest that might compromise the integrity of their analysis or advice, as recommended by the OECD Principles of Corporate Governance.²⁰
- *Guidance on behaviour expected from institutional investors:* financial regulators and supervisors also have a role to play in encouraging long-term, active investment. They can support national or international codes of good practice (such as the Stewardship Code which is gaining widespread support in the UK) and issue guidance themselves of how they expect institutional investors to behave. In order to ‘nudge’ investors to follow such guidance, supervisors can shift the focus on their investigations, enquiring as to the turnover of funds, the length of mandates given to external managers, how fees are structured, voting behaviour etc. If supervisors believe that investors may be acting in too short-term a manner, they could increase their oversight of the institution. Such actions could help address the agency problem, making institutional investors aware of their fiduciary duties and that they are the ultimate owners of the companies in which they invest, with the consequent responsibilities which that entails. Supervisory authorities could also help to foster a focus on longer-term performance by releasing or requiring comparative data on returns over longer time periods.

¹⁹ Principle II.F.

²⁰ Principle V.F.

3. Government support for long-term investments

39. Governments can shape the general investment policy environment to promote long-term investments and attract institutional investors to key sectors such as infrastructure, green energy projects, and venture capital. They can also support directly the management of long-term risks through information dissemination and the issuance of long-term instruments:

- *Supportive tax environment and policies to promote foreign direct investment:* investors' decisions are conditioned by a variety of policies that affect how companies finance their operations and how they expand overseas. In particular, tax policies have created a bias for debt over equity that should be corrected. Foreign direct investment is another important component of long-term investment and should be encouraged. The OECD has been promoting transparent and open markets for foreign direct investment, including through binding rules in the *OECD Code of Liberalisation of Capital Movements*.
- *Government issuance of long-term instruments:* policymakers should also help investors address long-term risks, such as longevity by supporting the development of transparent and reliable indices and other aspects of the market infrastructure. Government can also issue long maturity and inflation-indexed bonds that facilitate long-term risk management by investors.
- *Transparent environment for infrastructure investment:* Investment in infrastructure is a relatively new investment which entails a new set of challenges for institutional investors. Shortage of objective information and quality data make difficult to assess the risk of infrastructure deals. In addition, the financial crisis - which had significant impact on the performance of many infrastructure deals - greatly damaged the relationship and trust between the infrastructure industry and investors. As a consequence many institutional investors have a negative perception of the infrastructure value and are not considering investment in the sector in the short medium term, unless market conditions change. Governments should promote a more transparent investment environment as recommended in the: "OECD Principles for Private Sector Participation in Infrastructure." Governments could also improve transparency and understanding of the sector through independent data collection and common performance measures, whilst international organizations (such as the OECD) can play a role through creating a platform for dialogue between investors, the financial industry and governments.
- *Stable and accessible programme of infrastructure projects and public-private partnerships (PPPs):* the limited number and sporadic nature of investment opportunities in the infrastructure sector are perceived as the main barrier preventing investors from including infrastructure in their long-term investment strategy. Investors need a better sense of the government's infrastructure plans beyond the political

cycle. To the extent that they do not already exist, governments should support the development of national long-term strategic policy frameworks for individual key infrastructure sectors, including renewable energy and other low carbon initiatives. Governments also need to create an ongoing supply of investment opportunities through public-private partnerships. The regulatory environment for such initiatives should also be stable, helping to cement the credibility of the government and the trust of institutional investors in the government's commitment to pre-set rules.

- *Understanding the needs of institutional investors – providing appropriate investment incentives and risk transfer opportunities:* Governments should seek to better understand the investment needs and requirements of institutional investors and assess the scope for promoting the “right” investment opportunities. For instance, a common problem appears to be a mismatch between the desired risk/return profiles and investment horizon of pension funds when investing in infrastructure and the opportunities offered in the market. Through appropriate financial incentives (for instance, tax incentives and feed-in tariffs) and risk transfer mechanisms (such as guarantees and first equity loss on investments), projects should be structured as attractive investment opportunities for investors. Governments should also create the appropriate conditions to attract institutional investors to venture capital (financial market infrastructure, favourable regulations, and, where appropriate, seed capital and financing vehicles).

4. Financial education and consumer protection regulation

40. As a result of the ongoing risk transfer to individuals in both the insurance and private pensions sectors, investment strategies are increasingly affected by the behaviour of individual investors. Individual investors are often less well informed than institutional ones and subject to the same if not bigger behavioural problems described earlier. Policy action with respect to financial education and consumer protection regulation is vital to help investors make better investment decisions that are in line with their long-term goals.

41. Generally, there is a need to change the investment culture from short-termism towards longer-term productive investment. Policymakers need to act to address the specific needs of retail investors via three main routes:

- *An appropriate financial consumer protection framework* can ensure that an optimal level of transparency and redress mechanisms are in place in the financial sector thereby promoting consumers' confidence vis a vis mainstream institutional investors.
- *Tailored financial education and awareness strategies programmes* can in addition help consumers better understand their various needs for long-term saving and relevant existing insurance and pension products to address these needs. Such programmes can also raise awareness in the general public about the benefits of longer-term investing. In turn, retail

investors may start putting pressure on the institutional investors that represent them, either through their voice (for example, as member-nominated pension fund trustees) or actions (their investment choices).

- *Default mechanisms* supported by judicious financial education programmes may be put in place to compensate the low level of financial awareness at least in the short term. For instance, life cycle investment strategies, where investments become increasingly conservative as the member approaches retirement are increasingly being used as default investment rules in retirement savings plans.