Roundtable on Long-Term Investment Policy

Session Notes

26 November 2014
L'Hôtel du Collectionneur
Paris

10:00-11:00 Panel I: Long-term investing, Asset Allocation Concepts, and the Role of Policy Makers

Institutional investors have to cope with an ever-evolving environment. In the post-crisis period, the **low-yield environment** is a major factor influencing institutional investor decisions. Some institutional investors have turned to the **stock-market** in search for higher returns. Perhaps the most salient trend over the past few years has been the increasing allocations to alternative assets like private equity, infrastructure and hedge funds.

In many countries, institutional investors are subject to restrictions and constraints regarding asset allocation. Restrictions are useful at different stages of financial development, but having a direct impact on the asset allocation of institutional investors, they need to continuously evolve to not become an obstacle. Enabling institutions to make long-term capital commitments is an important objective for national and international policy-makers – long-term investments can play the dual role of helping governments finance productive investment while promoting **economic stability**.

The asset allocation of institutional investors is impacted by a lack of adequate investment vehicles for long-term investment. Not all options enable the investor to take full advantage of projects' characteristics. Innovative and well thought-out investment instruments are needed to promote long-term investment for institutional investors. **Policy makers, advisors and the financial industry need to work together to create these tools.** The OECD is working on identifying financial instruments and vehicles, regulatory and institutional conditions that can make infrastructure investment attractive for pension funds and insurers.

It is also important to stress the role of **regulation** not only regarding the investment side, but also regarding the sector in which investment is to be made. Since the investment is long-term, the investor needs assurance of long-term stability in this sector. Regarding infrastructure for example, regulation often has a key role in allocating profits from a project or influencing prices, and as such demand. A stable regulatory framework is highly important to attract long-term investment.

Issues for Discussion

- What are the recent trends in the asset allocations of institutional investors? What is the impact of the current low yield environment? Is there a continued shift away from 'core' fixed income towards high yield and other yield enhancing sectors? Are institutional investors continuing to increase exposure to emerging markets?
- Where can investors genuinely reap an illiquidity premium, and are incentive structures and capital markets efficient at facilitating investment?
- Assessing the impact of investment restrictions and constraints, such as limitations on foreign holdings or illiquid investments
- Are there recent examples of financial innovation, new investment instruments, or investment products in the institutional marketplace that support long-term investment?
- What can governments and regulators do to stimulate long-term investment by institutional investors? How to ensure the implementation of the High Level Principles for Long-term Investment by institutional investors?

Policy Initiatives and OECD Role

The OECD, along with other IOs, has been working with the G20, APEC and other organizations to further the agenda of long-term investment by institutions, in infrastructure in particular. Principal in this initiative is the G20/OECD joint Task Force on Long-Term Investment. The establishment of a formal network of institutional investors and policy makers is also under way, creating a platform for exchange and cooperation. In addition to the proposed network, the OECD is also organising a series of events, bringing together major investors and policy officials.

References

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11:30-12:10 Special Session: Pension Design and Long-Term Investing

Pension systems are facing crucial and far-reaching challenges. The economic crisis led to a reduction in governments' revenues to finance retirement promises and to a loss of public confidence in private pensions in many countries. At the same time, pension systems also have to deal with the problems posed by population ageing and the current economic environment.

Pensions are under pressure from the **retiring of the baby boom generations, the improvements in mortality and life expectancy, and the longevity risk** coming from the uncertainty around future improvements in life expectancy. Population ageing is leading not only to an increase in the number of people in retirement relative to the size of the working age population, but also most importantly to an increase in the number of years that people spend in retirement. While living longer and healthier lives is fundamentally good news, population ageing challenges the financial sustainability, solvency and adequacy of pension systems.

The current economic environment characterised by low returns, low interest rates, and low growth in advanced economies is compounding these problems. These factors may lead to lower resources than expected to finance retirement promises or simply lead to lower retirement income. **Lower returns decrease the expected future value of past contributions, as assets accumulated will grow at a lower rate than expected.** Low interest rates may reduce the amount of pension income that a given amount of accumulated assets may be able to deliver, especially in defined contribution (DC) pensions. Additionally, low economic growth may reduce the overall resources available to finance pension promises.

Annual **return requirements** might reduce the long-term view of the investor, leading to greater pressure on performance. This in turn leads to a promotion of **short-termism and pro-cyclicality.** For institutional investors, return requirements should be carefully established in a pragmatic fashion, and properly account for economic realities.

References

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OECD (2012), "Roadmap for the Good Design of DC Pension Plans", OECD Publishing.

OECD (2010), "Principles of Occupational Pension Regulation", OECD Publishing.

12:10-13:10 Panel II: Getting Real on Real Assets: Infrastructure as an Asset Class?

Investors have strong demand for real assets such as real estate, infrastructure and natural resources. This demand is linked to the desirable characteristics of such investments like long-term inflation-linked cash flows.

The demand for real assets is affected by high valuations in other markets. It is important to **understand how global financial trends affect investor demand**, in order to **find long-term opportunities matching the needs of institutional investors.**

The illiquidity premium for real assets, such as real estate or infrastructure, is what makes the asset category compelling vis-à-vis traditional investments. However, **describing and accurately pricing illiquidity** can be a **challenging endeavour.** For infrastructure specifically, it is essential to further analyse the specific opportunities of investing through equity or debt. Depending on the demands of investors as well as the real characteristics of the underlying asset, the mode of finance makes a significant difference. Using debt, or tranching debt, can expand the potential investor base to finance infrastructure projects. Micro-level data is needed to establish proven practices in a comprehensive way. Through this process, better advice can be provided regarding future infrastructure projects.

Issues for Discussion

- Is there still a strong investor appetite for adding real assets such as real estate, infrastructure, natural resources and commodities?
- Amid a sea of high valuations, where can investors still find attractive opportunities? How are high valuations affecting investor demand?
- What is the illiquidity premium for real assets such as real estate and infrastructure? What are the virtues of investing in infrastructure through equity or debt instruments?
- What are some of the barriers -regulatory or market- that institutional investors face when considering infrastructure investments? How can they be overcome?
- To what extent do various real assets actually provide inflation protection?
- Are governments acting to improve the supply of high-quality appropriately-structured infrastructure opportunities relative to high demand? How can this be accomplished?

Policy Initiatives and OECD Role

The high demand for infrastructure investment on the side of the investors needs to be met by an adequate supply on the side of the government. Comprehensive analysis of practical steps taken in various countries, like the Report on Effective Approaches to Support the Implementation of the G20/OECD High-Level Principles on Long-Term Investment Financing by Institutional Investors, yields important insight on ways to provide opportunities for investment. Continuous enhancement and larger coverage of such work will provide the basis for solid and efficient policies.

The OECD is undertaking data collection exercises to identify the extent to which institutional investors are investing in infrastructure and to better understand the role and performance of alternative assets from an investors' perspective. The Long-Term Investment Project at the OECD produces an annual survey of large pension funds' investment behaviour. A similar exercise for leading insurance companies is currently in preparation.

References

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14:20-15:20 Panel III: Governance for long-term investors: Practices in a Dynamic Investment Environment

Informed, knowledgeable investors are the basis for good governance and a proper alignment of incentives. Raising the bar of governance among institutional investors is essential to create the right incentives among asset managers to better look after the long-term interest of beneficiaries. Over the longer term, well-governed institutional investors are expected to generate higher returns (adjusted for risk and expenses) than poorly governed funds.

The nature of institutional investors has evolved over the years into a **complex system** of fund management companies with their own corporate governance issues and incentive structures. **Investment chains have also lengthened**, increasing the distance between the final beneficiary and an investment in an enterprise. Investment strategies have also evolved with **passive investing** through indices and exchange traded funds becoming more important so as to lower costs and increase returns to beneficiaries. Against this background, the question of **investor oversight of company boards** needs to be examined.

Not all of the arguments in this debate relate specifically to good corporate governance but to their **potential for underpinning growth and development, and addressing other issues such as environmental and social goals.** However, there is a close relationship between good corporate governance that promotes company performance and accountability, and addressing these broader issues.

Issues for Discussion

- What changes to the investment process and governance structure can be made to better take advantage of market opportunities?
- How have Investment Policy Statements evolved to adapt to changing market conditions?
- How important is active ownership engagement within the institutional business model?
- How can one make sure that an investor's governance model does not undermine a long-term investment view?
- Fiduciary duty and impact investing – balancing the interests of many stakeholders
- Do governments, policy makers and industry leaders do enough to encourage good governance practices? What are the emerging best practices?

Policy Initiatives and OECD role

Relevant work is being carried out by the OECD International Network on Corporate Governance, the UNPRI and the UK Government Independent review ("Kay Review") of Equity Markets and Long Term Decision Making launched in September 2011.

References

ITUC/TUAC (2014) Global Union Call for Action for Pension Fund Responsible Tax Practices.

Celik, S. and M. Isaksson (2013) "Institutional Investors as Owners: Who are They and What Do They Do?", OECD Corporate Governance Working Papers No. 11, OECD Publishing.

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15:20-16:10 Panel IV: Charting the Future: The Regulatory Environment, Taxation, and its impact on Long-term Investors

Regulation is an important driver of institutional investors' asset allocation. It is very important to keep in mind how new regulation might impact investors' ability and desire to invest over the long-term.

Financial reporting, accounting rules and **disclosure requirements** can limit insurance companies' and pension funds' ability to adopt a long-term scope regarding investment. **Solvency rules** and related **mark-to-market accounting** might unintentionally promote pro-cyclicality in investment portfolios. It is important to understand the consequences of new regulation regarding asset allocation and to make sure not to restrict investors with the goal to invest over the long term. There is evidence that regulatory changes have driven a large part of institutional investors to the same asset classes, also known as **herding**. This can lead to sub-optimal asset allocation and challenge the financial stability of the system if combined with **pro-cyclicality**. A certain degree of **regulatory flexibility** is healthy, but the extent of it must be carefully examined.

High discount rates might discourage infrastructure investment if return hurdles are not high enough and entail excessive risk-taking in order to achieve them. **Policy makers need to find the right balance** between transparent, consistent regulation regarding risk, and the operative room to invest in more illiquid, long-term assets.

Recent **tax reforms** discussed at the G20 level (e.g. BEPS) may also affect institutional investors. A dialogue between policy makers and industry groups is essential to make out points of conflict regarding long-term investment. **Tax reform needs to be carefully designed in order to promote long-term investment**. Policy makers have the instruments to promote long-term investment via this channel.

Issues for Discussion

- How do financial reporting, accounting rules, and disclosure requirements negatively affect insurance and pension funds' ability to maintain a long-term view?
- Are return requirements for many investors, such as pension funds, unrealistically high? Are rules related to liability discount rates and assumptions conducive to long-term investing?
- To what extent may this drive investments that are not in the long-term best interest of stakeholders?
- How will tax reforms discussed at G20 level (e.g BEPS) affect institutional investors? Are there potential unintended consequences for them?
- How do regulatory pressures, such as the need to mark assets to market, affect institutional investors' ability to deliver long-term success? Does this fuel procyclical behaviour?

Policy Initiatives and OECD Role

The OECD is undertaking research to provide a comprehensive comparison of international regulatory environments regarding long-term investment. This will enable policy makers to assess the impact of different approaches to regulation. The OECD is also analysing the effects of current and impending changes in taxation.

References

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16:35-17:20 Panel V: The Green Revolution ESG Factors in Long-term Investment Decisions

The investment needs in "green infrastructure" to address sustainable growth and climate change, are estimated to be about USD 36-42 trillion between 2012 and 2030. Comparing to today's investment, this makes for an investment gap of USD 1 trillion annually. In addition to climate and energy security related benefits, investment in green infrastructure could also lead to substantial fuel savings of about EUR 170-320 billion annually and health benefits of around EUR 88 billion per year up to 2050.

Institutional investors are conscious of the special role green investment can play in their asset allocation. A number of pension funds already use ESG criteria as a factor when evaluating investments. However, in most cases these allocations remain relatively small. The transition to a green economy is a long-term project, in need of long-term financing. **Institutional investors such as pension funds and insurance companies can provide the capital if the right incentives are in place.** This requires a supply of competitive projects in line with the regulation these investors have to face. Green infrastructure projects have shown to yield attractive returns to institutional investors, but only if the deals are adequately structured. It is also important to distinguish among institutional investors to design deals specifically targeted at a group of investors.

Policy makers play a central role in addressing one of the key issues of green investment: **pricing-in environmental protection.** Institutional investors will only consider green projects that are profitable and present an advantage over non-green ones. However, green infrastructure still is often more expensive. This is one of the fundamental barriers to green investment: the lack of a clear pricing of low-carbon production and more generally of the "green" factor. If officials want to encourage institutional investment in green infrastructure, they need to **provide financial incentives and long-term regulatory security.** Policy changes are too frequent regarding climate policy, investors need protection against future changes in order to reduce uncertainty.

Issues for Discussion

- Renewable energy and green infrastructure investment: what are the concrete examples?
- Green bonds: what are the opportunities in the world's largest asset category, and how can the emerging green bond market mature into a liquid, mainstream and investable sector?
- Direct investment and YieldCos on the equity side have emerged as new channels for institutional investment in green infrastructure: what are future expectations for these channels?
- How can policy makers support green investment by institutional investors and the further use of ESG criteria?
- What are the challenges to green investment particular to developing economies? How can they be overcome?

Policy Initiatives and OECD role

The OECD can benefit from horizontal cooperation within the organization, bringing together experts in finance and environmental economics to create synergies. This has already resulted in a number of reports addressing the issue. At the 2014 UN Climate Summit, the special role of institutional investors in financing green growth was acknowledged, setting the stage for future work.

References

Waygood, S. (2014), "Aviva White Paper: A Roadmap for Sustainable Capital Markets: How can the UN Sustainable Development Goals harness the Global Capital Markets?"

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17:20-17:45 Special Session: Challenges in Long-Term Investment The Role of Policy Makers

Policy makers have a **crucial role** in promoting long-term investment, setting a framework suitable for long-term investment, looking at issues such as regulatory and accounting requirements, investment restrictions, political uncertainty and fiscal and financial incentives.

Various initiatives to make new sources of financing available to SMEs, green investment and infrastructure have been or are currently undertaken not only at the national level, but also by **international institutions** such as the EU Commission and the G20. A particular focus in these processes is long-term investment. The EU Commission has recently formulated a new proposal for **a European Long Term Investment Fund**, a vehicle intended to open up alternative sources of capital to long-term projects. It is also working towards a European Capital Markets Union with the goal to reduce barriers to investment inside Europe. A comprehensive legal framework should make capital more mobile.

The G20 is working with International Organizations to promote long-term investment on a **global level**. At their November 2014 summit, the G20 leaders welcomed the OECD's Report on Effective Approaches to Support Implementation of the G20/OECD High-Level Principles on Long-Term Investment Financing by Institutional Investors. The heads of state also commissioned a G20/OECD Checklist on Long-Term investment Financing Strategies and Institutional Investors at an earlier meeting.

Good governance and ESG are also important topics to be considered by policy makers. How to best encourage investors to take into account **social and environmental factors** into their investment decisions is not only an internal issue of the funds. International cooperation is necessary to provide the right framework for good practices to be implemented. ESG is a wide topic, incorporating various environmental and social issues. Some of these issues, like the question of tax-evasion or tax-risk, are best met by a coordinated international effort.

References

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Speech by Jonathan Hill, EU Commissioner for Financial Stability, Financial Services and Capital Markets Union (2014), "Capital Markets Union – finance serving the economy"