OECD High-Level Financial Roundtable: Fostering long-term investment and economic growth

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Financial Reforms to Foster Stability and Long-Term Growth

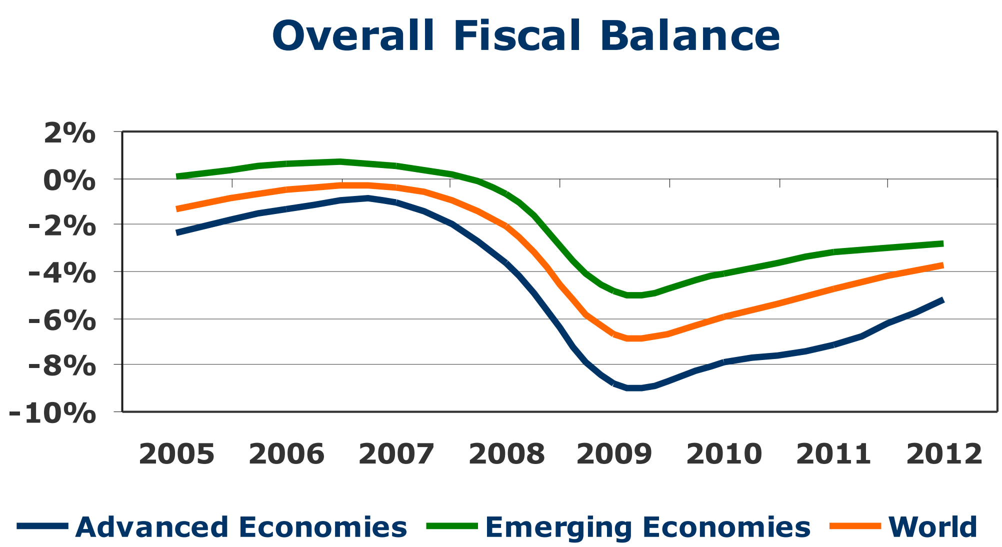
After the Pittsburgh G-20 call for a strong, balanced and sustainable growth, the focus of global community seems to have shifted mostly on financial and fiscal stability. Since high public debt and financial instability are considered as the main carriers of the crisis, they have become the main guiding lines of the action of regulators and policy makers in the aftermath of the crisis. There is general consensus that they represent central pillars of a healthy and well-functioning economic system.

The correlation between financial and fiscal stability is self-evident: the Irish and the Portuguese crisis are excellent examples of it. Both financial and fiscal stability are conditions of a durable and healthy growth; they are strictly related to the expectations of economic agents and to the planning of economic activity. A well balanced fiscal and financial environment increases the opportunities of economic growth.

But there is also evidence that this correlation is - in fact - a bidirectional one. Durable and sustainable growth requires financial stability and a long-term fiscal consolidation; but financial stability and fiscal consolidation both require a durable and sustainable growth. Among others, the Chairman of the Financial Stability Board, Mario Draghi, has recently repeatedly emphasized this point.

As it is well known, the financial crisis had a significant impact on the public finance of most advanced countries throughout the world. Considering the 33 advanced economies as defined by the World Economic Outlook, in 2009 the budget deficit averaged about 9 per cent, up from only 1 per cent in 2007.

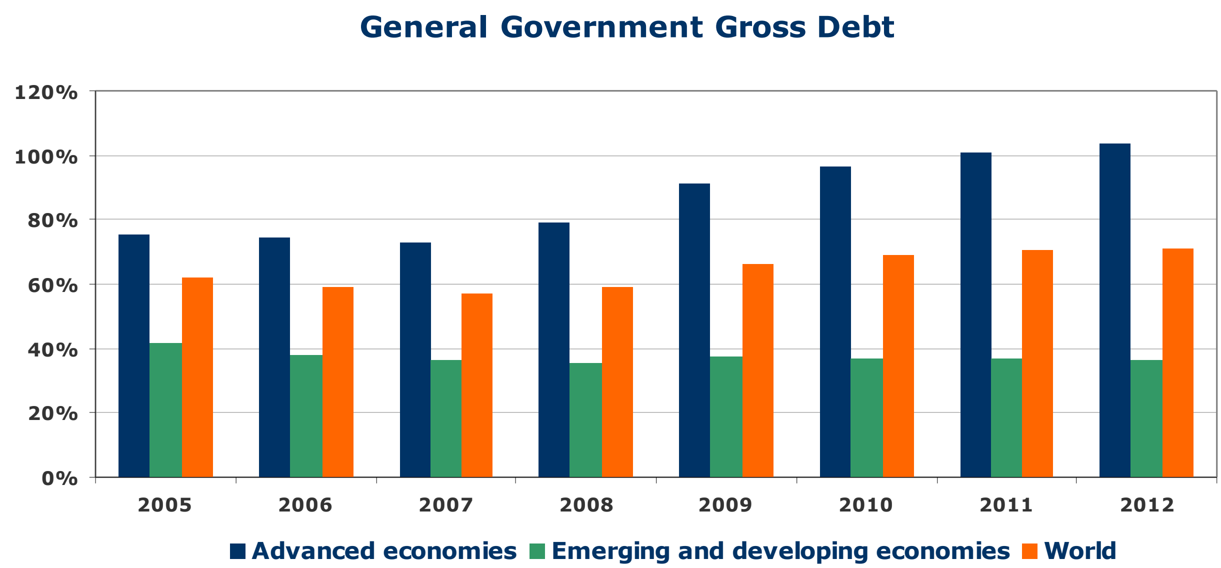
Figure - 1. Deterioration of Fiscal Balance



Source: IMF 2010.

The level of public debt/GDP ratio of G-7 countries soared to post-war levels. For the "advanced economies" within the G-20, this ratio peaked to 102.7% in 2010, while the public debt of the emerging countries remains broadly stable at much lower levels (36.9% in 2010).

Figure - 2. Increase in public debt

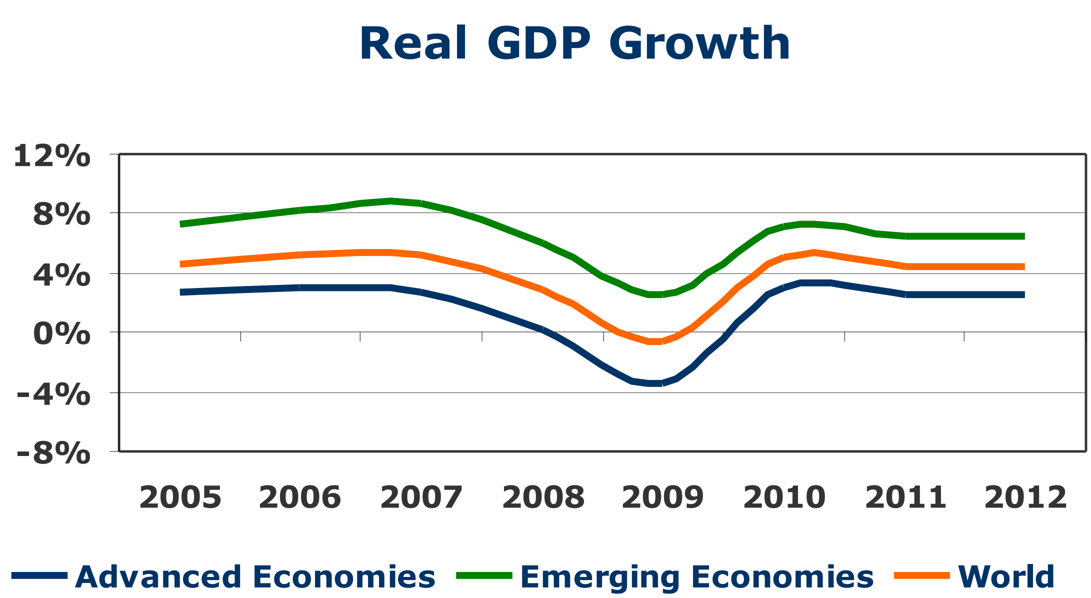


Source: IMF 2010.

Thus, most advanced economies need then to lower their deficit and their debt substantially. Strong inflation could reduce public debt, but we know that high inflation distorts the allocation of resources, reduces the growth rate, hits the poorest citizens, and creates social and political instability. Major cuts in public spending are necessary, but politically difficult. In the long term, they may seriously jeopardize the government's political consensus. Thus, together with relevant but sustainable cuts in public spending, increasing the average rate of GDP growth is then the most desirable solution to restore fiscal stability. Reforms to liberalize markets, boost competition and cut regulatory burdens are always necessary, but on their own may not achieve the desired results. Increasing investment is always crucial to fostering economic growth. This is particularly true for investments in strategic sectors able to generate high positive externalities, like infrastructure, research and technological innovation, the environment, alternative energy servicing, and biotechnologies. They could enhance competitiveness and productivity.

However, the sudden strong increases of public debt and deficit levels imply that, today, government spending cannot provide the desired level of investment. Consequently, high-public debt countries will not be able to finance such investment mainly with their own budget resources, as high-growth and low-public-debt countries (such as China, Korea, Russia, Brazil, Australia) can do (and decided to do). So, mature countries need to attract an increasing amount of private capital to replace declining public capital, to increase their share of LTI to exit the crisis, to reinforce their growth rates and competitiveness on global markets and to ensure public debt sustainability (successful fiscal long-term consolidation requires both stricter fiscal policy and more economic growth).

Figure - 3. Dual speed growth

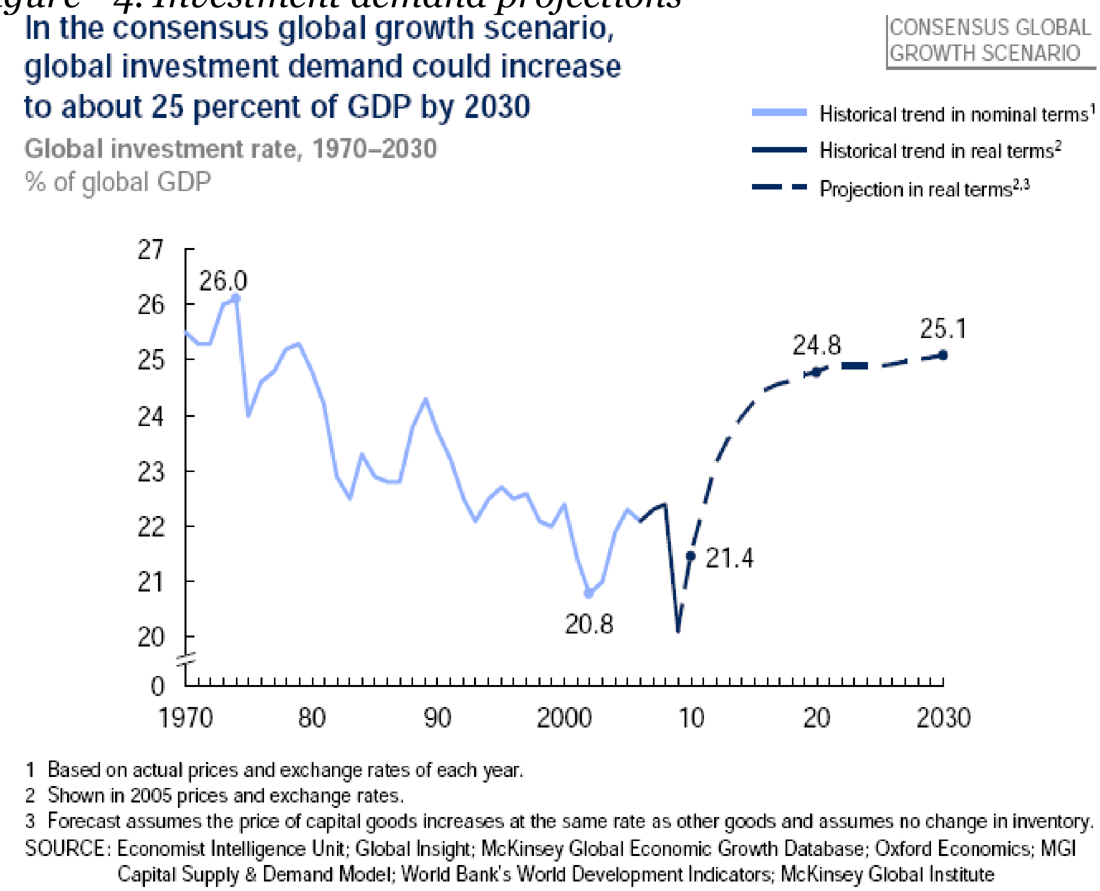


Source: IMF 2010.

But the developing countries too need to increase their investment in strategic sectors; for instance, rapid urbanization, climate change and the income per capita catching up process are requiring vast investment in infrastructure (transportation, urbanization, TLC, energy, water supply…).

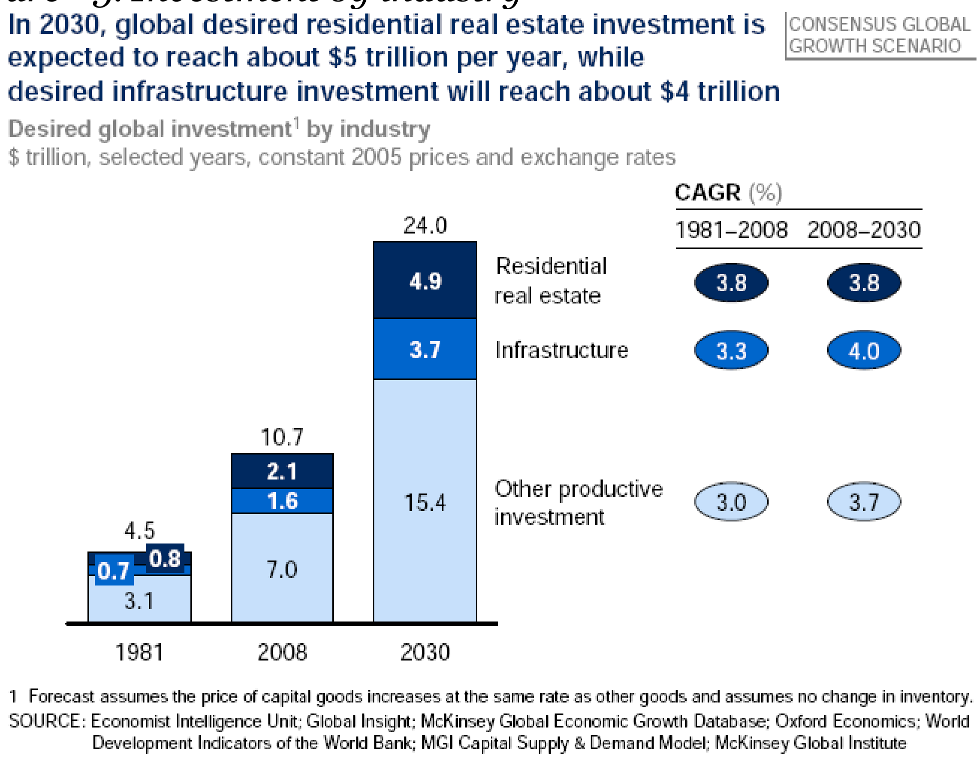
Consequently, worldwide demand for long-term investment (LTI) in infrastructure, energy, climate change, urban infrastructure, technology and innovation, is expected to be very large: the world will encounter a potentially enormous wave of capital investment. Recent estimates project a huge global demand for real investment: 4 trillion US dollars in infrastructures; 5 trillion in residential real estate; 5 trillion in other productive assets in 2030 in a consensus global growth scenario (McKinsey 2011).

Figure - 4. Investment demand projections



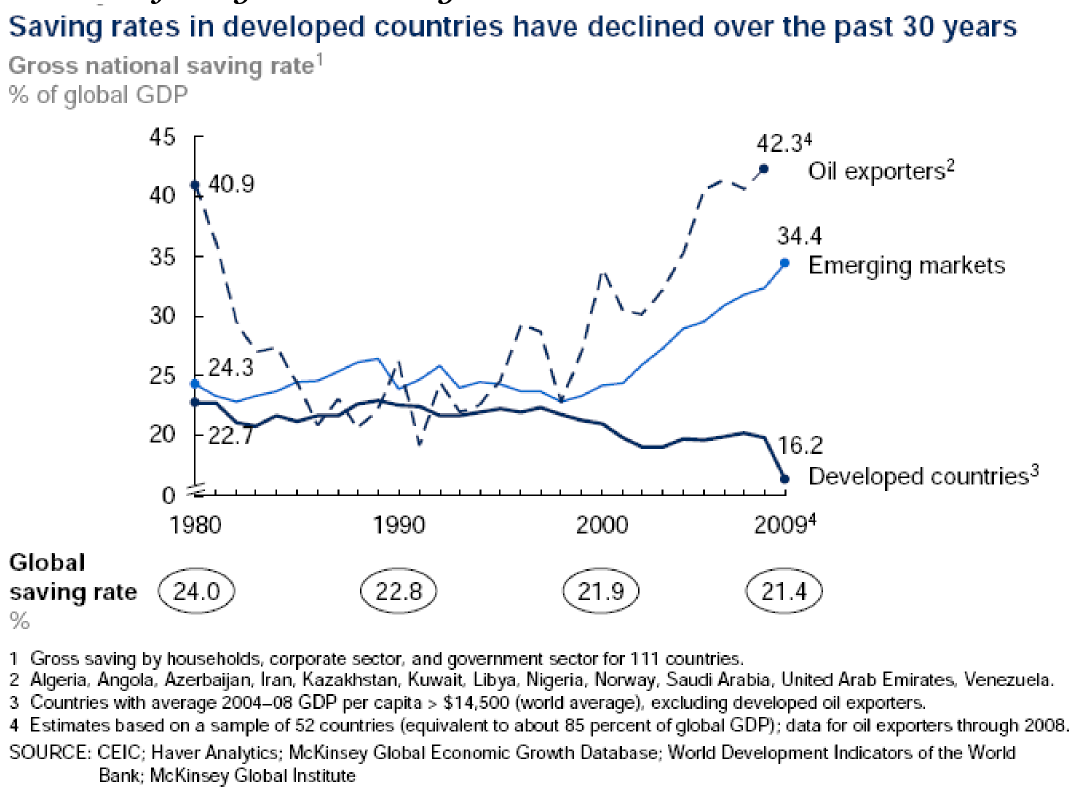
In Europe alone, by 2020 the EU Commission estimates 500 billion euro to complete the TEN-T system, 2,500 billion euro in Energy and Climate Change. These are all sectors that may yield stable long-term investment returns, stimulate follow-on investment, and, as a result, create growth in jobs. Furthermore, these kinds of investments should play a central role in changing the model of growth by increasing the share based on public and common goods, which reduce CO_2 emissions, and decreasing the share produced by consumer goods, which generally increase CO_2 emissions.

Figure - 5. Investment by industry



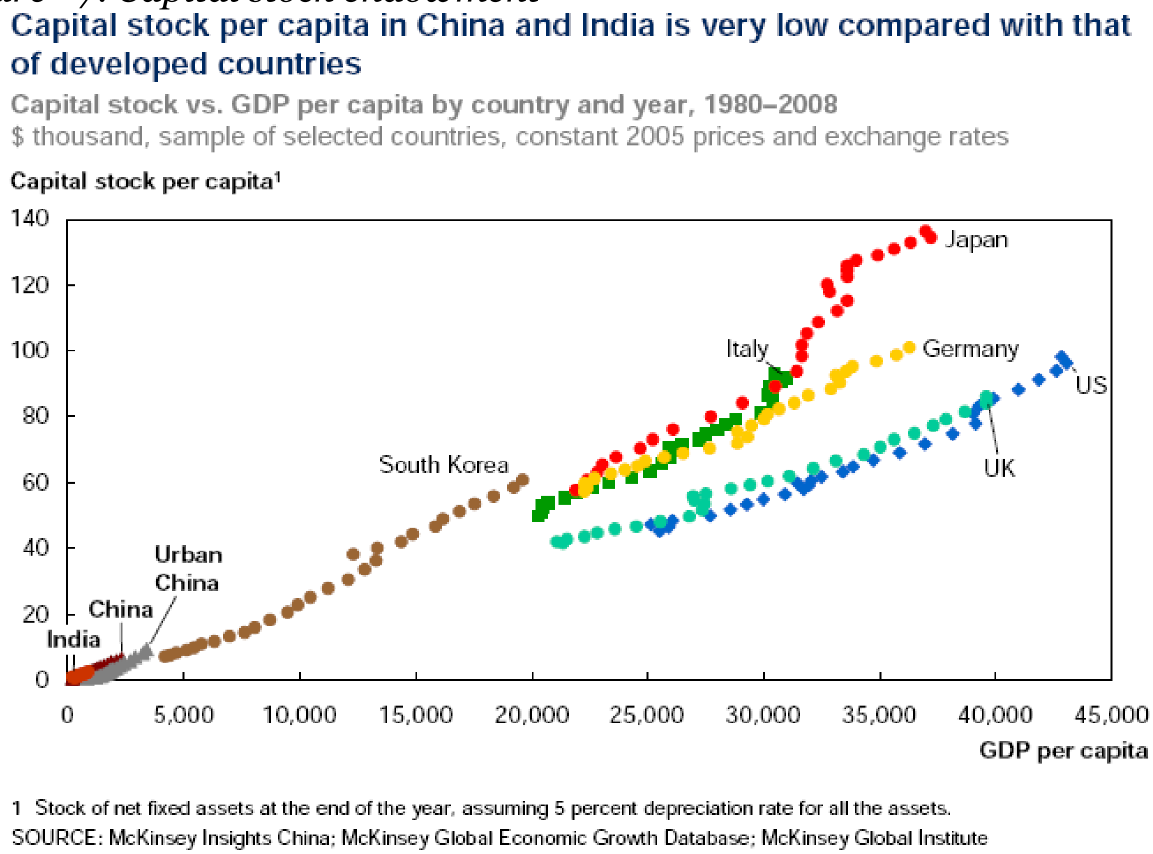
In the future economic growth scenario, according to consensus forecasts, saving may not increase enough, leaving a substantial gap between the willingness to save and the need to invest. This difference between the demand for capital to invest and the supply of saving will likely increase real long-term interest rates. Given the scarcity of long term finance, the competition for capital will be intense. The risk of a capital crunch (equity and credit crunch) will be high.

Figure - 6. Shift in global saving



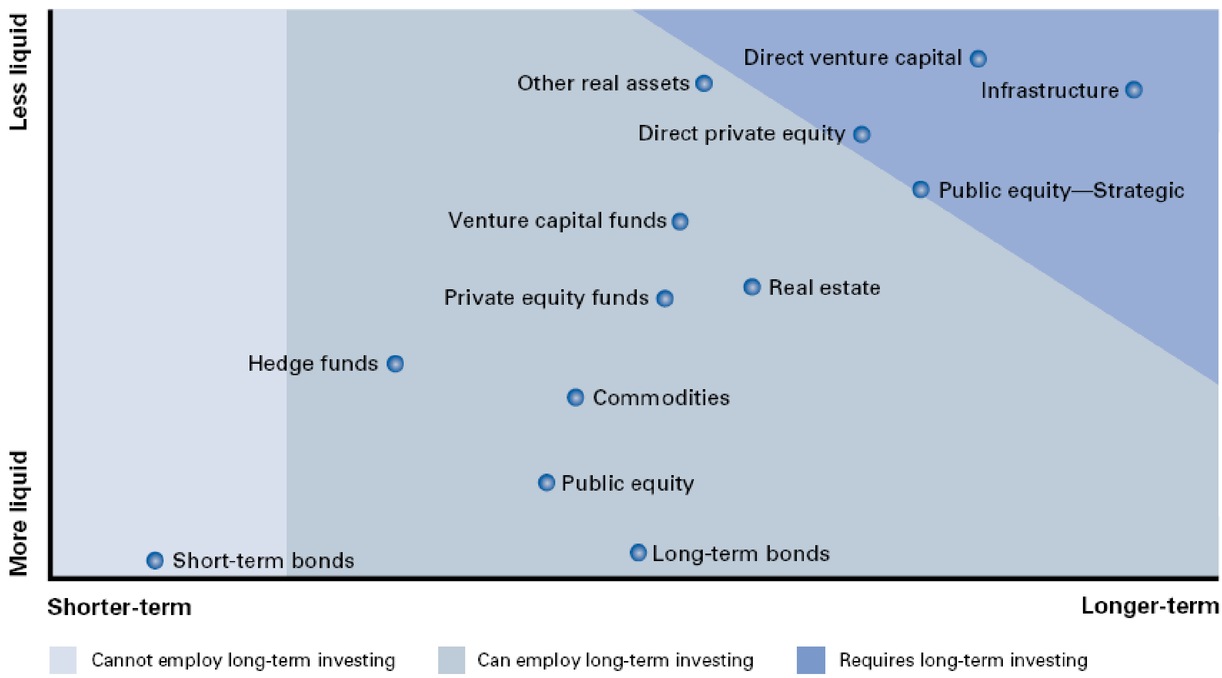
The presence of global imbalances, if properly directed, is not necessarily undesirable: the rebalancing of global savings could lead to a different resource allocations, reducing the imbalance of the infrastructural and technological endowment between the emerging and the advanced countries. This could produce, in the meantime, a more robust growth in advanced countries and potential gains in terms of revenues, technological transfers and innovation diffusion in the emerging ones.

Figure - 7. Capital stock endowment



Thus, all countries in the world should increase their level of long-term investment and participate to a fair competition on global financial markets to attract private and public-private resources to finance them. There is a general need to enlarge the worldwide share of financing for long-term capital investment at the expense of the short termism and speculation. We need to favor the match of long term saving and long term capital investment. New regulatory frameworks, friendlier to long-term investment, should be adopted on every level, national, regional and global.

Figure - 8 Features of long-term investment



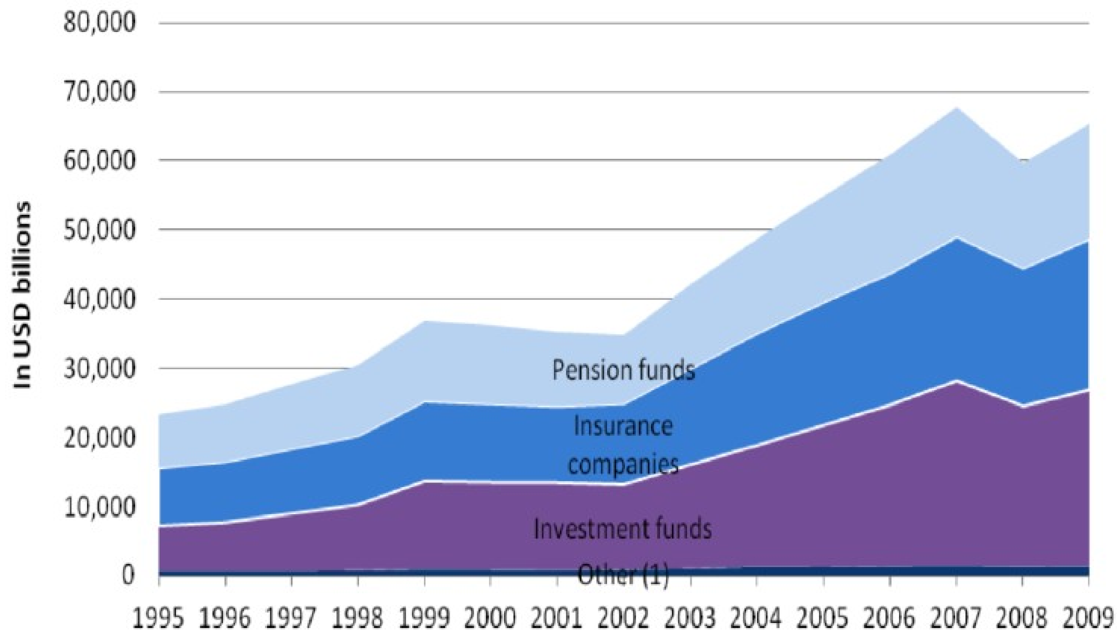
Source: WEF 2010.

Policy makers and international regulators around the world should work not only to assure financial stability, prevent global crisis and "level the playing field" to allow for fair global competition on the markets of global savings, but they should also work on creating a prudential and accounting framework that encourages managers of financial institutions to focus more on long-term rather than on short-term results, especially on investments with significant positive externalities for growth. Nevertheless, the overall regulatory setting has often been providing unfavourable incentives to LTIs and to long-term oriented investors. In particular, accounting rules that are appropriate for investment banks and trading activities are not very relevant and sometimes penalising for LTIs because they promote short-termism. The new Basel III capital requirements and liquidity will probably discourage long term banking and financial initiatives. Moreover, the IASB mark-to-market philosophy is particularly damaging for long term investments, attributing instant market values to assets the value of which is by essence based on several years[1]; and the Solvency II Directive, in Europe, will discourage insurance companies and pension funds from holding infrastructural assets, not allowing for a proper matching of long term liabilities and assets on their balance sheets

Large long-term institutional investors are in fact potential recipients of financial instruments for initiatives in project financing. With assets estimated at 50/60 trillion dollars (30 trillion, excluding investment funds, but including pension funds, insurance companies, SWFs, endowments funds and development banks - World Economic Forum, 2010 and OECD, 2011), they may represent huge players in financing growth stimulating investments.

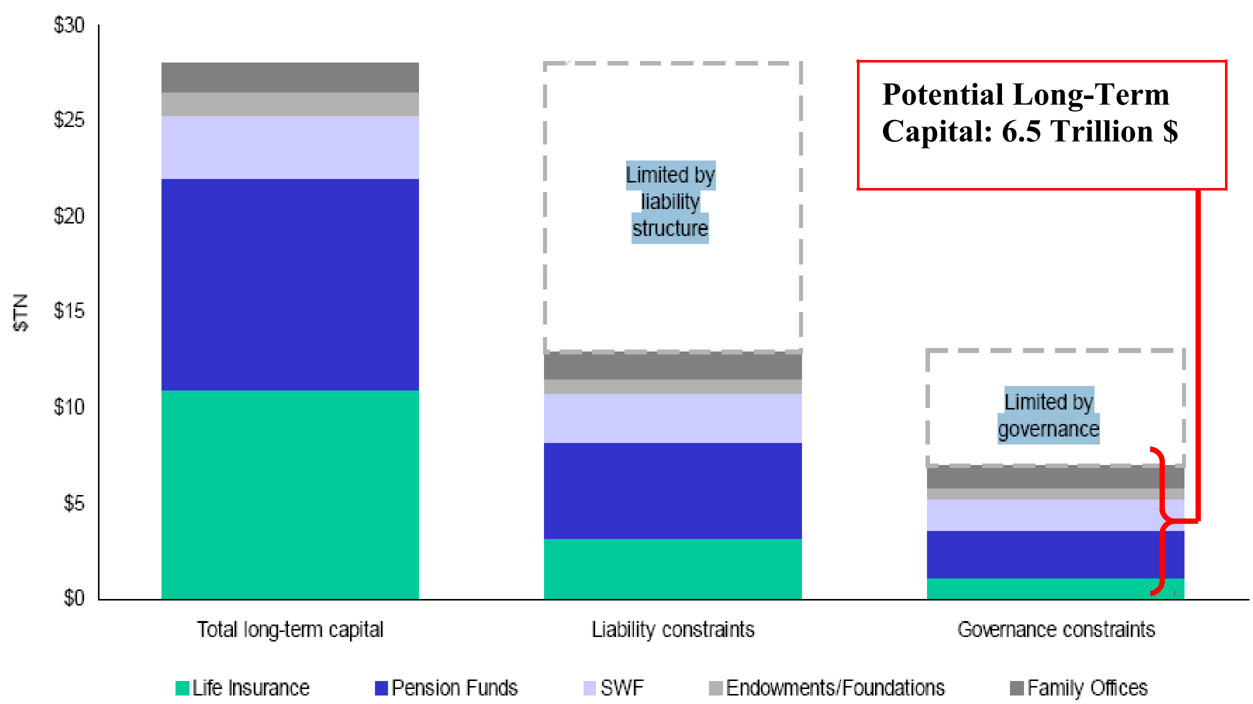
[1] Current accounting standards, as recently pointed out by Jacques de Larosiére (*Long term investment: what appropriate regulatory framework?*, The Long-term Investment in the Age of Globalisation, Rome, 17th June 2010 in http://www.astrid-online.it/Dossier--d1/DISCIPLINA/The-Long-T/index.htm), involve two conceptual difficulties: in the IAS Board's philosophy, a company's assets and liabilities must be valued – in general - separately and independently; second, in many cases this valuation must be based on current values (marked to market). This specific valuation approach (IAS 19 and IAS 39 for instance) is particularly damaging for LTI. Indeed it consists in attributing instant market values to assets the value of which is by essence based on several years. By doing so, market volatility is immediately transferred to investor's balance sheet and profit-and-loss account. Moreover, the current accounting reporting system does not make it possible to check the quality of the fit between assets and liabilities. For instance it is questionable whether short-term fluctuations in interest rates and asset prices should immediately be recognized since occupational pensions have long-term commitments. These two difficulties represent major pitfalls for financial communication in terms of the investor and supervisory authorities, as well as for customers, intermediaries, shareholders, etc. The accounting rules set up for trading activities do not take into account the differences between business models of financial institutions. This short-term horizon would strongly constrain the capacity of these types of long term investors to hold stocks and other types of long term infrastructure based assets.

Figure - 9 Long-term investors breakdown



Institutional investors are starting to invest directly in core infrastructure assets; they are increasingly becoming familiar with such as asset class and are today better equipped to source and execute transactions and manage assets.

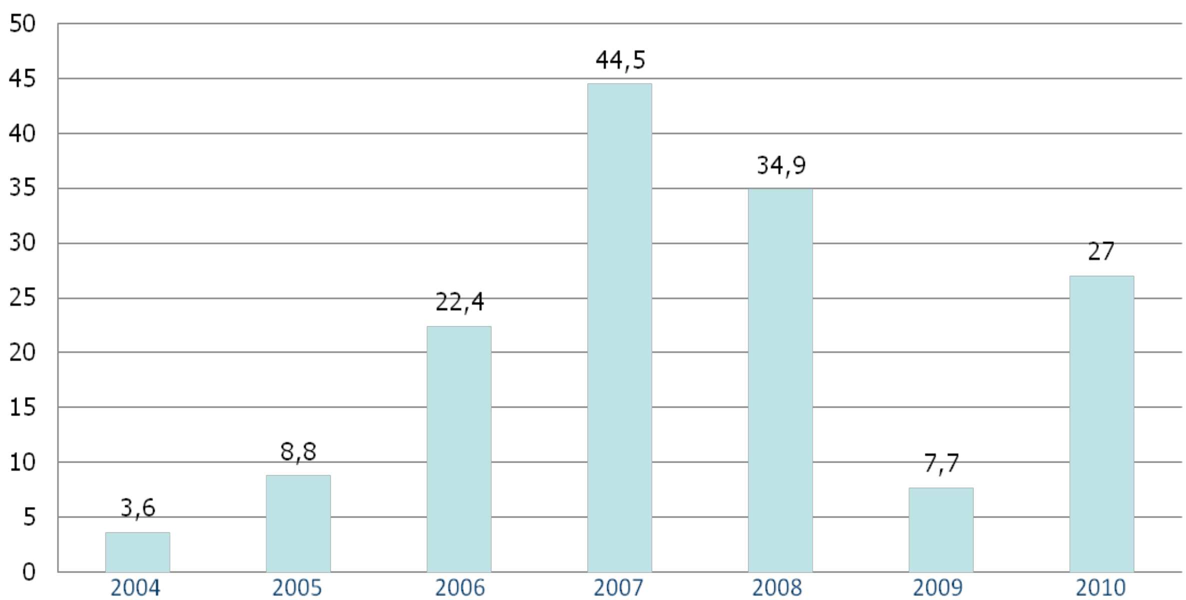
Figure – 10 Long-term investors constraints



Source: WEF 2010.

Today on average they invest around 2% in infrastructure, as an asset class (Morgan Stanley, 2011). Potentially their balance sheets could have room for over 7 trillion of dollars in long term assets, a larger part of which could be invested in equity or debt for infrastructure (World Economic Forum, 2010).

Figure – 11 Equity Funds

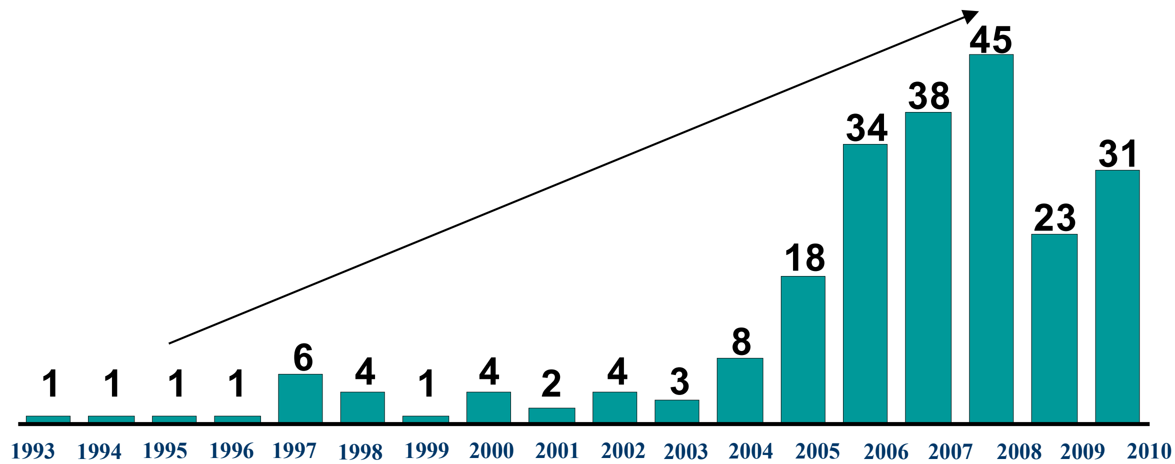


Source: Prequin.

In the coming years the demand for both equity and debt for financing infrastructure is going to increase. The Private Equity industry for infrastructure, after a sudden decline during 2008, is raising up again. Both “Brownfield” and “Greenfield” initiatives maybe attractive asset classes for large investors. They need, however, a well designed regulatory framework. Still the demand for financing (especially in equity) is larger the supply, leaving open the question whether will have to face in the future an infrastructure “Equity Crunch”.

In this context we want to emphasize the importance of looking at long term institutional investors for what they are: i.e. long term risk takers and long term asset holders. If enough investors with a long term horizon were active in the financial market place, they could act - as they used to - as shock absorbers i.e. increasing liquidity and reducing volatility through buying in depressed markets.

Figure 12. Creation of Funds



Source: Prequin.

But even more importantly they could become a powerful financial long term engine for a strong, balanced and sustainable global growth.

Constraints placed on LTI are to be carefully evaluated in specific contexts. For instance, a defined benefit pension fund is characterized by long-term and very long-term liabilities and tends to invest with a long-term horizon; its asset allocation basket includes items that are perceived as ‘rich’ in the long run. When long-term liability replication is problematic and a good proxy-portfolio consists of risky assets which work out their balancing role only in the long run, the immunization of the balance sheet to very short-term changes in the risk factors is inefficient. This is why short-term constraints on pension funds are mostly irrelevant for long-term investors that do not face short-term solvency concerns. By the same token, the attribution of instant market values to assets whose value unfolds over the long term is questionably useful.

As for Basel III, in principle, the EU is not obliged to transpose the Basel rules mechanically, but could provide for exceptions and integrations, as the U.S. did for Basel I and II. However, strong political and practical reasons suggest not to reopen the Pandora's box of Basel III. *Stricto jure*, in fact, the rules of Basel III apply to banks, but do not apply to LT investors like insurances, pension funds, SWF's and, in general, to development banks like EIB, CDC, CDP, KfW. However, on one hand Basel rules inspire Solvency rules and the regulations of other LT players; on the other hand, de facto and by default, the same rules (or very similar ones) are frequently applied by the markets (for instance, rating Agencies) to these investors, dramatically reducing their firepower in financing LTI. There is good reason to fill the void with an additional or integrative protocol to Basel III or another international document establishing which of the Basel-like rules are relevant for the different categories of LT investors and which are instead the special rules and exceptions designed for the specific mission and business model of these institutions.

There is, moreover, an even better reason to define criteria to spot the real quality of LTIs in order to link a more favourable prudential regulation to specific strengths (i.e. strategic nature of the investment, implicit government support, strength of collateral guarantees,.....).

Since the beginning of the crisis, in several occasions the Long-Term Investors Club (LTIC, including, in Europe, EIB, KfW, CDC and CDP) has posed questions and made suggestions relating to prudential and accounting regulations to policy makers and international organizations. In 2009 at the

Paris Conference[2] and then at Eurofi Financial Forum held in Goteborg[3] various proposals to foster European LTI were first presented. Further work by our institutions in 2010 has been put forward by participating actively in the preparatory activity of the Jacques de Larosière and Mario Monti reports. Other initiatives were taken by the Club's members at the 2010[4] Eurofi Financial Forum, by the two conferences organized by the LTIC and the OECD in Rome and in Venice[5], and by a working paper presented to the EU Commissioner Michel Barnier by four prominent European long-term public investors (EIB, KfW, CDC and CDP) in September 2010[6].

At the European political level, the need for a new regulatory framework, more favourable to LTIs, was strongly emphasized by the European Commission – following the Jacques de Larosière and Mario Monti reports - in the communications on *A New Single Market Act*, on *A Comprehensive European International Investment Policy* and on *The EU Budget Review*. In fact, without a substantial increase in investment in infrastructure, energy, environment, innovation and research, and therefore without major changes in prudential, accounting and tax regulations, the objectives set in the EU 2020 strategy and in the Mario Monti Report could hardly be achieved. Major investments in the

[2] *The promotion of long-term values and economic stability*, 22nd June 2009 in partnership with the OECD. The conclusions of the June 22 Paris Conference have been presented at the 10th Annual OECD Forum, in Paris on June 23 and 24, 2009.

[3] *What priorities for the incoming EU authorities in the light of the financial crisis?,* the *Eurofi Financial Forum* 2009, 29 September to 1 October, Göteborg.

[4] *Optimizing EU financial reforms for achieving resilience, growth and competitiveness. What priorities? What roadmap?*, the *Eurofi Financial Forum* 2010, 27th – 30th September 2010, Brussels. See especially the paper *For an EU action plan to remove the disincentives to long-term investment.*

[5] *The Long-term Investment in the Age of Globalisation,* Rome, 17th June 2010 (all papers in *http://www.astrid-online.it/Dossier--d1/DISCIPLINA/The-Long-T/index.htm*) and *Towards a Sustainable Future: The Role of Long-Term Investment,* Venice, 28th-29th Oct. 2010 (all papers in *http://www.astrid-online.it/Dossier--d1/DISCIPLINA/Studi--ric/index.htm*).

[6] Letter to Mr. Barnier, *Proposals to adapt the EU's financial regulatory framework to long-term investments requirements*, 20th September 2010, with annex *Proposals to promote Long-term investments in Europe – Conclusions of European long-term financial institutions' working group on banking supervision.*

fields of innovation, renewable energies, water networks, telecommunications and transport infrastructures are in any case required for shifting to a low-carbon economy, coping with the scarcity of natural resources or adapting to rapid urbanization.

* * *

But a friendlier regulatory framework, which should be adopted at national, regional and global levels, should involve not only accounting standards and prudential principles, but also tax incentives, better (sectoral) regulating mechanisms for project financing initiatives, and corporate governance systems designed to stimulate, overall, long term rather than short term investment allocations.

Tax incentives may become part of Governments' contribution to long term investment. Fiscal incentives for long-term investment should be very effective to attract capital flows on this long term investment vehicles. The US has given a prominent role to new financial instruments, such as the Build America Bonds, with strong fiscal incentives to attract domestic and foreign savings to finance infrastructure, energy, and social and urban initiative.

Indeed, most tax systems favor debt finance over equity, since interest is deductible against corporate profits, while dividends are taxed. As a consequence, this lowers the after-tax cost of capital of debt-financed investments compared to equity-funded investments. Although equity finance allows corporations more flexibility to undertake fixed investments since it does not impose strict repayment conditions, the more favorable treatment of debt may lead to less effective capital structures and encourage excessive indebtedness. Neutrality of financing choices should not necessarily be achieved by removing deductibility of interest payments, but by granting equivalent advantages to equity financing.

In the case of investments now requiring public grants to be attractive, tax incentives may replace the lack of direct public financial resources. They may have powerful positive effect and, in the long run, repay its “public” cost by extending the tax base on capital investment itself.

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

Finally, the corporate governance model of the so-called “shareholders’ value” is partly responsible for the short-termism that characterized recently global capitalism. Such a model places the maximization value of the shares at the centre of the stage, before the industrial or social value of the firm. The management is contractually linked only to the shareholders and not to the workers, or to the stakeholders or, more generally, to the industrial future of the firm. The managers of the firm are ‘winners’ if they maximize the value of the shares, which is directly related to generous bonuses and stock options. This mechanism has created strong incentives to maximize short-term - rather than long term - value, compounded by the unintended short-term bias produced by prudential and accounting regulations, as illustrated above. In this respect, the FSB has elaborated principles on compensation in the financial sector that we wish will be adopted swiftly by all jurisdictions ad mandated also by the G20[7].

There is also the necessity to create new long-term financial instruments mixing public and private funds. We may draw from the European recent experience in developing new EU institutional long term financial instruments such as equity funds (such as Marguerite and InfraMed funds), EU project bonds, and more generally, credit enhancing mechanisms to lower the risk and decrease the cost of long term initiatives in strategic sectors such infrastructure, energy and technology.

* * *

In conclusion, an intense competition for long-term finance will characterize the world in the coming years. The sensitivity of long-term growth to the cost of capital; the absolute need to remove regulatory disincentives against long-term investment; the urgency of avoiding excessive regulatory zeal are all elements of the new scenario which should be carefully taken into consideration by policy makers and by national and international regulators.

We tried to show that the two goals – stability and growth - are not mutually exclusive. They are, in fact, interconnected in so far as a well calibrated regulation is more friendly to long term investments which, in turn, contribute to growth, financial stability and fiscal sustainability. Strategic investment in infrastructure, energy, telecommunications and human resources have strong positive externalities for the economy as a whole and for human well-being and may be the cornerstone of a strong, balanced and sustainable growth. With a

[7] "We urge all jurisdictions to fully implement the FSB principles and standards on compensation. We call on the FSB to undertake ongoing monitoring in this area and will assess the results of the 2nd peer review on compensation practices by our next meeting" *G20 Communiquè*, 14-15 April, Washington DC.

better regulation, they may be financed by private investors without burdening drained public budgets.

A good regulation, in short, must be able to promote ‘virtuous circles’ between stability and long-term growth.