ISSN : 1287-4558

Analyses Économiques vol. X-04 (July 2010)

The Newsletter of the French Council of Economic Analysis

The CAE is an independent, non partisan advisory body reporting to the French Prime Minister, whose members belong to the academic community, as well as to the business and government sectors. Reports issued by the Council represent the views of their authors only, not those of the CAE (which does not take policy positions) or of the French government. The reports, which are published together with comments by discussants and background papers, can be downloaded free of charge from our website www.cae.gouv.fr. Each issue of this newsletter, which is released by the Council's permanent staff, focuses on a particular report.

Long-Term Investments and Investors

Report by Jérôme Glachant, Jean-Hervé Lorenzi, Alain Quinet and Philippe Trainar

EDITORIAL

Just as the global recession and the more recent crisis in the eurozone have prompted numerous economic agents to shorten their forecasts and strategies, so uncertainty (regarding employment, pensions, etc.) is pushing up household savings rates.

The problem linked to savings in most European countries, including France, is more a problem of quality than quantity. It is about attracting a higher proportion of private savings to long-term investments in order to boost growth and employment.

The report aims to refine the diagnosis, to shed some light using comparisons in time and space, and proposes concrete recommendations to counteract random and sometimes unfavourable change, without for as much underestimating the strong constraints that will weigh on public finances for several years to come.

Christian de Boissieu
Executive Chairman of the CAE

Channelling abundant 'long' savings into investments that are profitable in both social and economic terms will be crucial in the next ten years in order to create jobs and stimulate activity. For Jérôme Glachant, Jean-Hervé Lorenzi, Alain Quinet and Philippe Trainar, France, like other industrialised countries, must encourage the emergence of long-term investors that are able to bear long-term risk. The report contains ten proposals on how to achieve this that focus on the constitution and mobilisation of long-term savings and the creation of long-term investment vehicles that involve both the public and private sectors.

The report was presented to Jean-Paul Faugère, Chief of Staff to the French Prime Minister, on May 27th 2010.

This letter was published with the approval of the permanent group and presents the main conclusions drawn by the authors.

Global economic imbalance

Today's global economy is wrought with imbalance as abundant capital is diverted away from projects that are nonetheless vital if developed economies are to flourish and developing countries are to progress in social terms.

Global finance is struggling to merge the horizons: while savings are lengthening on the back of demographic change and growth in emerging countries, the horizon for investments is retracting. This inability to point capital in the direction of socially and economically profitable projects is the focal point of the report. Certainly, the financial system is not the only factor behind this hoarding and tangible under-exploitation of capital, but it is at the end of the chain and must match up supply and demand for goods and services by levelling the playing field between savings and investments.

Long-term investors are a rare breed

Investing over the long term requires renewed financial intermediation, a diversified ecosystem in which long-term investors play a decisive role.

Sovereign funds, pension funds, insurance companies, government investment funds – all of these categories in their broadest sense manage long-term savings which can sometimes span generations and which are strategically important when it comes to securing and safeguarding the absolute advantage of an economic zone.

The actions of long-term investors are useful in themselves when, because of their investment horizons, they act as informed, patient shareholders who participate in the governance of the companies they control. They have even more merit when we consider the balance they bring to the markets, particularly during a recession. Having said that, their actions are nowhere near enough to counteract an insatiable appetite for asset-backed securities and encourage investors to take longer risks.

In the OECD countries, and in particular in France, long-term investors are a rare breed. First, the state, which in theory has the longest investment horizon, no longer has the means to invest. Second, new prudential and accounting frameworks are shortening the horizons for institutional investors, with the banks' ability to transform capital and the investment capacity of insurance companies and funds restricted by the Basel II and III agreements and by the Solvency II Directive. Third, France has no real pension funds which means that households are the 'left-over' long-term investors which is not the best way forward (lack of information, cost of tax incentives, etc.).

This situation amongst industrialised countries contrasts with that in emerging countries where long-term investor numbers are growing strong. As such, sovereign funds are thriving on the imbalances in the global economy. For industrialised countries, it would be easier to attract emerging sovereign fund investment if they themselves had their own long-term investors who were willing to reciprocate.

A French and European financial architecture to encourage long-term investment

To date, the globalisation of the finance sector has primarily concerned assets that were thought to be secure, especially sovereign bonds, to the exclusion of longer investment vehicles associated with radical and strategic risks. These risks are systemic risks and their even distribution is not something that can be achieved via the markets, particularly the global markets. It depends more on governments which are able to spread them between present and future tax payers. Add to that the continued domestic bias affecting the composition of investor portfolios, and we can conclude that long-term finance will continue to develop more at a local level (tax sovereignty) than at a global level. Channelling household savings towards risky, long-term investment is a core priority for the coming years.

Against this backdrop, Europe and France must build a financial architecture which resolutely works in favour of the extension and securitisation of horizons and is supported by long-term investors. Long-term investment requires the right balance between the place of the markets and governments on the one hand, and a national, European or global framework on the other.

Ten proposals

The report puts forwards ten proposals to encourage the channelling of long-term savings into long-term investments. Some are tied to the supply of capital through the stimulation of long-term savings, and others to the demand for and intermediation of capital amongst long-term investors. To fully grasp these proposals, they need to be read bearing in mind the asset liability management logic of an investor. Bringing the horizons in line is crucial: it is not simply a question of developing long-term savings, but above all of making sure investors are prepared to take long risks. To achieve this, a sensible balance needs to be found between the financial mechanisms of a correctly regulated market (accounting and prudential framework), and the long-term guarantee mechanisms provided by the authorities. While the financial markets are able to manage short- and medium-term marginal risks when they are correctly regulated, only the authorities, as a last resort insurer, can absorb systemic long-term risks. Long-term investment therefore calls into question the role of the state when it comes to assuaging fears.

The proposals below first look at what can be implemented very quickly, and then what will require further discussions with our partners, notably in Europe.

Stimulate the supply of long capital

The short-term objective is to find, from amongst the reserves accumu-lated by households[1], the 30 to 50 billion euros needed to bolster and direct our structures in responding to the challenges that go with a greener economy and an ageing population. To achieve this, the report proposes (proposals 4, 6 and 7) that greater weight be lent to long-term savings products that pay out annuities. Aside from the advantage they present when it comes to managing the risk of higher life expectancy for households, annuities are the best method for long-term investors to back their long assets as the development of the Anglo-Saxon super annuities markets clearly show. Here, France's structures can be easily corrected by acting on stocks and flows. In terms of stocks, the report proposes that channelling some life insurance savings into pension savings in the form of annuities be made easier. The switch could be carried out with an immediate tax reduction. For flows, the complex taxation of annuities constitutes a major obstacle for the development of these products. Moreover, the taxation linked to PERP retirement savings plans could be more neutral.

As far as taxation on savings is concerned, the authors of the report believe that it should encourage households to invest more in long-term products and be almost entirely neutral for these products.

The 10th proposal concerns long-term and indirect bond financing for French SMEs and takes into account the specific context of the latter for which bank credit remains crucial. Life insurance companies are partial to property bonds, a secure mortgage refinancing product that has held up well in recent years. When it comes to refinancing bank loans to SMEs, this type of securitisation could be replaced by a shared platform for the issue of asset-backed bonds.

Intervening on accounting and prudential standards and the structure of investment funds

Badly-conceived accounting and prudential standards can be an obstacle to the development of long-term investment. The application of the Solvency II Directive governing insurers prompted debate as to the structure of investment funds and the level of securitisation of life insurance liabilities, and a number of positive changes were made. The issue is critical for France, where life insurance has various uses, notably as a form of long-term savings for retirement. To a certain extent, France's insurance companies occupy the same place as pension funds in other economies. However, the fact that insurance companies are a specific type of long-term investor is not sufficiently recognised and even disregarded by the Solvency II Directive. As such, the report's 3rd proposal is that France defend the status of long-term structural investors (ISLTs) that are midway between insurance companies and pension funds. The 5th proposal recommends that the amortized historical cost method be used as an accounting basis for financial investments by ISLTs or, failing that, for the proportion of these investments that are long-term investments.

The report also puts forward a number of proposals linked to the structure of investment funds. In more specific terms, economic literature has proven that open-end funds[2] encourage short-termism on the markets which is passed on to businesses *via* their governance. It also shows that, in the opposite case, closed-end funds encourage measured, long-term investments like venture

(1) At the end of 2008, the financial holdings of households in France amounted to around € 3,500 billion, over one-third of which is invested in life insurance policies. In 2009, household savings levels in France amounted to € 88.4 billion compared to € 61.2 billion one year earlier.

(2) A fund is open when investors are able to liquidate their positions without being subject to any restrictions.

capital and infrastructure funds. Proposals 8 and 9 advocate the development of closed investment funds that invest in both listed and unlisted companies, which could take their inspiration from venture capital governance structures.

Setting up private-public sector long-term investment vehicles

The report proposes spreading risk between the private and public sectors for certain specific projects. The vocation of the public sector is to manage long-term and extreme exposure, whilst private investors bear the day-to-day risks. As set out in the report's 1st proposal, the idea is to set up private-public sector investment vehicles in which the state can invest contingent capital in the form of hybrid debt which would allow it to transfer its long risk. Drawing on a careful and targeted selection of general interest projects, a fund could be set up in which the state can invest alongside other private long-term investors. The companies would be selected by the fund, and the type of capital invested (in the form of hybrid debt) would be entirely consistent with the manner in which the state invests in the fund. The report cites two fields in which a fund or several funds of this type could be set up:

- to reinforce Europe's defence capacity,
- to overhaul vocational training structures.

Comments

In his comments, ***François Bourguignon*** considers that this is an interesting report on a difficult and relatively unexplored topic. He would have liked the analysis to be based on a more rigorous and convincing measure of the imbalance between long-term savings and long-term investment. As regards the proposals put forward, he believes that the idea of collective backing for long-term investments is an appealing one. He nonetheless considers that its practical implementation would be a delicate task given that the shortcomings of the markets prevent the definition of suitable rates.

For ***Grégoire Chertok***, the main issue of the report is the role of the state in long-term investments and the manner in which its intervention can counteract the short-termism of the markets. The limits imposed by flailing public finances and European regulations on government subsidies put the authors' proposals into perspective. Between the short-termism of the markets and government intervention, there are other avenues to be explored to broaden investment horizons: employee shareholding, family capitalism and the development of retirement schemes through capitalisation..

List of proposals

Proposal 1

Dedicate vehicles associating public and private sector to targeted long term investment projects.

Proposal 2

Promote an insurance process for systemic financial risks in order to narrow the standards or coverage of financial institutions by their equity capital.

Proposal 3

Distinguish specificities of long term investors by delivering a status of 'long term structural investor' for investors usually working with provident funds as a regular activity.

Proposal 4

Add an option for life insurance contracts for transforming it in pension scheme with tax deduction if decided before the age of 55.

Proposal 5

For investors of proposal 3, refer to the historical cost after depreciation for accounting matters.

Proposal 6

Simplify and secure tax neutrality for life annuities whatever the age of the beneficiary.

Proposal 7

Promote the PERP retirement saving plans with better fiscal deduction rules.

Proposal 8

Advocate the development of closed investment funds of equities, including small and mid caps.

Proposal 9

Create closed investment funds for financing capital stock for innovating firms composed of venture capital and small caps equities.

Proposal 10

Encourage an indirect access of SMEs to bonds markets for refinancing loans through a specific common shared platform for issuing asset-backed bonds.

La documentation Française
113 rue de Grenelle 75007 PARIS [France] Ph.: (33-0)1 42 75 53 00 – Fax: (33-0)1 42 75 51 27
Publisher: Christian de Boissieu – Editor: Pierre Joly – Electronic Publishing: Christine Carl