LONG-TERM FINANCING

Investor Perspectives in Europe

Overview
In the aftermath of the global financial crisis, a more diversified set of intermediaries between providers and users of capital is deemed desirable, with public budgets under severe pressure and the commercial banking system struggling to recover. Investors, at both the individual and institutional level, may play an increasingly important role in directing capital to long term investment projects.

In recognition of the need for alternatives to public capital to fund development and reinvigorate European economies, the European Commission in March 2013 issued a Green Paper on Long-Term Financing of the European Economy to investigate how to create productive and efficient channels for directing capital from savers to users involved in the creation and maintenance of tangible (such as infrastructure, housing, climate change technology) and intangible (such as research and development and education) assets. Such long-lived capital projects are often characterized by cash-flow patterns that take time to generate returns on initial investments, and are also often fairly illiquid by nature.

CFA Institute Perspective
In its 25 June 2013 comment on the Green Paper, CFA Institute reflected opinions as developed in a poll of 381 investment professionals who are members. Important priorities cited by CFA Institute include:

- **Regulatory Framework:** A regulatory structure at the EU and national level that incentivizes long-term investing is essential.
- **Short-termism:** Asset owners should hold asset managers accountable for performance over longer-term evaluation horizons rather than the current tendency to focus on quarterly returns.
- **Investment Vehicles:** Innovation in developing new pooled fund vehicles targeted towards infrastructure and other long-term investments (‘Long Term Investment Funds’) is welcome, and can afford investors important diversification opportunities. We caution that any such new investment vehicles should offer enhanced disclosure to investors regarding risks and redemption restrictions.
- **Securitisation:** A revival of the securitisation market is welcome but must not be characterized by the complexity and opacity of deals in the past. We propose a special designation that would distinguish those long-term investments that satisfy a suitably high standard of disclosure quality.
- **Fair-Value Accounting:** We refute the notion that fair-value accounting policies contribute to short-termism and assert that fair-value can in fact reduce the information asymmetry that exists between issuers and investors as to the value of corporate assets and liabilities.

Impact of Regulation on Long-Term Investors
Institutional investors in particular may find long-term investment opportunities attractive in view of the typically long-term nature of their liabilities. Insurance companies or pension funds with long-lived obligations to pay well in the future need not necessarily insist on investment opportunities that offer immediate liquidity or indeed immediate returns, and may find advantage to closer alignment of their asset-liability structure. In this regard, such investors can be ‘patient’ and counter-cyclical as needed. But prudential regulatory mandates adopted in the aftermath of the financial crisis may operate at cross purposes to facilitation of long-term investments, as the objectives of reducing moral hazard and safeguarding the capacity to make good on promises to pay benefits in the future are prioritized.
Insurers are subject to a new regime of capital charges per the Solvency II Directive in the European Union. In 2012, the European Commission wrote an open letter to the European Insurance and Occupational Pensions Authority (EIOPA) to ask that it determine whether a reconciliation of the prudential objectives of Solvency II and incentives (or lack of disincentives) for long-term investments was required. In 2013, EIOPA determined that adjustments to the capital charges required by Solvency II were not required to account for any novel risks associated with long-term investment projects.

CFA Institute remains concerned that prudential rules for insurers may in fact discourage holdings of long-term assets (including equities) in favor of shorter-term instruments. In a poll of CFA Institute members, 60% of respondents indicated that they believe prudential regulations such as Solvency II reduce incentives to invest in long-term assets. In light of recent experience, we look forward to further analysis of appropriate solvency rules, including consideration of whether so-called ‘risk-free’ assets (such as sovereign debt) with corresponding light capital charges are appropriately characterized.

### Appropriate Time Horizons for Evaluating Investment Performance

Although institutional investors have long-term horizons that are consistent with the longer-term nature of their liability structure, it is common practice to evaluate the performance of the investment managers retained to manage assets on their behalf on much shorter time horizons — sometimes as short as quarterly. Investment managers, in turn, are incented to perform over the short term rather than adopting strategies that are best suited to longer-term horizons. This potentially includes consideration of investments in less liquid assets with cash flow characteristics that do not reward the assumption of risk in the short term. Asset owners may be required or encouraged to consider short-term performance by the regulatory regime they are subject to.

<table>
<thead>
<tr>
<th>Performance evaluation based on short periods</th>
<th>Client regulatory requirements</th>
<th>Client preferences</th>
<th>Consultants’ preferences</th>
<th>Other</th>
<th>No opinion</th>
<th>I don’t think there are any barriers to investment in long-term assets</th>
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<tbody>
<tr>
<td>70%</td>
<td>49%</td>
<td>40%</td>
<td>20%</td>
<td>8%</td>
<td>4%</td>
<td>3%</td>
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Fully 70% of CFA Institute members surveyed cited ‘performance evaluation based on short periods’ as a barrier to investment in long-term assets. Both asset owners and investment managers should be encouraged as a matter of best practice to discuss appropriate evaluation periods and relation to liability structures and potential constraints on the selection of assets; the resulting policy should be recorded in an investment policy statement for ready reference by both parties. Both risk and return should be
analyzed periodically, but investors and investment managers alike should have common understanding of why there may be short-term anomalies in either dimension and what impact that has on achieving longer-term objectives. This analysis, in turn, can serve as a basis for ongoing assessment of the investment manager’s performance in furtherance of the investor’s primary objectives.

The Role of New Investment Vehicles in Facilitating Long-Term Investment

Those CFA Institute members polled find potential in introduction of new investment vehicles to facilitate the allocation of capital to a variety of long-term investment opportunities. Direct investment poses many challenges, including the requirement for analytical talent on the part of individual investment management firms; concentration of risk in specific investment projects; and structures that require limitations on liquidity, reflecting the cash-flow characteristics of many long-term investments. Creation of a Long Term Investment Fund (LTIF) investment vehicle in the EU, separate from the existing UCITS structure, can be an effective mechanism for addressing many of the shortcomings of direct investment and allowing smaller investors opportunity to allocate capital to such projects.

We caution, however, that development of LTIF structures should account for the unique characteristics of the underlying assets in all investor disclosures, with particular regard to the likely limitations on investor liquidity and novel risks associated with the underlying assets. This is especially important if individual investors are to have access to these investment opportunities. Full transparency as to the underlying LTIF assets and risks and constraints associated with LTIF investments should be of paramount importance.

We also support a revitalization of the securitisations markets. Securitisation offers the potential to tailor characteristics of securities more specifically to the risk and return objectives of investors. But complexity of securitised deals and opacity as to underlying assets both conspire to reduce the attractiveness of these structures for investment. Any resurgence of this market must reflect full transparency of the composition and risks of underlying assets, and more straightforward design of the securitised structure itself. We also urge efforts to reduce differences within the EU with regard to rules related to how securitised pools are originated and administered, as these differences currently pose obstacles to investors who may consider these assets for investment.

CFA Institute suggests consideration of a voluntary standard of structure and documentation that could transcend national differences in regulatory and legal frameworks that tend to create complexity and difference currently. Those structures that meet this voluntary standard could be awarded a designation easily recognizable by investors, which would in turn be reflected in pricing of such structures the lessened risk posed by incomplete or opaque disclosure.

CFA Institute members polled also see potential in structures that commingle long-term investment project finance bonds, as a way of diversifying risk and increasing access to more than just the largest investors. Some members also see merit in exploring structures specific to SME financing as a way of spreading risk and targeting SME finance needs more explicitly.

Fair Value Accounting Does Not Contribute to Short-termism

The Green Paper notes that accounting standards and measures reflect a tension between competing objectives of representing an economic interest and a financial/investor interest. The Green Paper also poses the question as to whether fair value accounting ultimately discourages assumption of risk by investors, and thus tends to discourage investment in long-term investment assets.
CFA Institute disagrees with the premise that fair value accounting is a contributory factor to short-termism on the part of investors. The value of fair value information has been confirmed through several polls of CFA Institute members who are a very diverse group of investors with varying investment strategies, asset class specialties, and time horizons. Of the members who identify as value investors, and thus might be expected to have the longest time horizons, we see no evidence that these investors consider fair value information not to be beneficial.

The connection between fair value reporting and investor appetite for risk suggested in the Green Paper seems mostly anecdotal and not supported by empirical evidence. We believe that derisking by investors is more reflective of the economic cycle and other confounding factors (relative level of interest rates and levels of inflation, for example.) We also note that bond investors use financial disclosures to develop perspective on financial condition and risk just the same as equity investors do.

While the focus of the Green Paper is on potential short-termism behavior by investors, we recommend consideration of the potential for short-termism on the part of issuers if fair value accounting is absent from the reporting landscape. Recent history suggests that ‘gains-trading’ and other suboptimal balance sheet management tactics were prevalent prior to requirement of fair value measurement for financial instruments, likely due in part to the potential to link short-term results with compensation of corporate management.

We recommend that presentation and disclosure requirements be enhanced around fair value measurement to help investors distinguish between realized and unrealized portions of fair value gains and losses. We also urge sufficient transparency around the fair value determination so that investors can interpret reported information in the proper context relative to other measurement bases applied. We disagree with any emphasis on using the business model as a basis of determining whether fair value measurement for financial instruments is appropriate. Financial reporting comparability is reduced when similar financial instruments (e.g., sovereign bonds) have different accounting treatment due to differences in the intended holding period by management.

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