Finance Watch response to the questionnaire on long-term investment funds

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Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. Its members represent, collectively, many millions of European citizens and include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

Finance Watch is funded by grants, donations and membership fees. It does not accept any funding from the financial industry or political parties. For 2012, Finance Watch has also received funding from the European Union to implement its work programme (there is no implied endorsement by the European Union of Finance Watch's work, which is the sole responsibility of Finance Watch).

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Only the questions that are relevant to Finance Watch are reproduced here.

For further questions, please contact Frédéric Hache, senior research analyst at Finance Watch.

Preliminary remarks

Long term investing faces well documented objective constraints, behavioural biases and in some cases conceptual flaws.

Objective constraints range from a lack of long term opportunities, measurement and governance arrangements biased towards short term performance, to regulation excessive focus on liquidity.
Behavioural biases against long term investing are many and include our natural tendency to prefer short term over long term decisions, our preference for immediate returns over delayed ones (especially when the return horizon is likely to be longer than that of a CFO or fund manager career), and our tendencies to overweight short term information and to cut losses early.
Finally, **conceptual flaws** on the definition of what risk and diversification are or on how to measure long term performance also play a frequent a role in impeding long term investing.

Added to these constraints, a combination of several recent trends is creating a "scissor" effect expected to lead to a **massive gap in global infrastructure funding over the next decade**. Some of these factors include growing infrastructure funding needs, Member States' fiscal consolidation leading to reduced public spending, ageing populations, banks' deleveraging after the crisis, and new regulation reducing the ability of traditional long term investors to invest in the long term.

As the private sector is expected to fill the gap, this consultation, amongst other regulatory initiatives, aims at exploring whether the creation of private longer-term investment fund vehicles might help institutional investors to get involved in infrastructure investment, and how to make them attractive to all stakeholders.

While we agree that market financing is part of the solution to fill the gap, we would make two remarks:
First we believe that **bank lending should not be so quickly dismissed** and work should be done to incentivize bank loans with a maturity longer than the current average commercial bank loan maturity of 4.2 years in developed countries[1]. We believe indeed that it is preferable to have risk located within institutions whose expertise is precisely to manage risk, rather than outside.
Secondly some market solutions require very careful designing: as an example the promotion of securitisation currently being considered can be part of the solution but

[1] Long term finance and economic growth – Group of Thirty
*www.group30.org/images/PDF/**Long-term_Finance**_lo-res.pdf*

not in its pre-crisis shadow banking form, rather with very limited leverage, maturity transformation and no principal–agent problems[2].
As another example, the design of new funds dedicated to long term investments might require a broader rethink of risk and performance metrics, governance arrangements and regulatory focus on liquidity.

Given the key benefits for society and the strong public interest dimension of long term investing, we are convinced that policy makers have a key role to play in designing the proper incentives and regulatory framework to ensure the right outcomes for society. We therefore strongly welcome this questionnaire.

Answer to the questions raised in the questionnaire

5. TO BE COMPLETED BY EVERYONE

17. If the European Commission were to design a common framework for LTI funds, what would be the most important features of such funds that would make them attractive for you to invest in them?

a. What types of investors should the fund focus on (institutional, high-networth, retail)?

Given the large need for long term financing and the fact that different types of investors have some capacity to hold assets for a very long time, we would recommend a large scope targeting both institutional and retail investors.

The key criterion is to target investors with the financial capability to invest with a long term horizon, and we believe that both types have the appetite and the capacity to dedicate more of their assets to long term investing.

Within that scope we would prioritize institutional investors, and in particular traditional long term investors, as a new vehicle if properly designed might contribute to some extent, together with other measures outside the scope of this consultation, to increasing the percentage of their assets invested long term.
These traditional long term investors are indeed currently allocating only 25% of their assets under management to long term investments[3] and while the constraints that they

[2] See "Shadow banking and financial instability" Adair Turner (March 2012)
[3] The future of long term investing – World Economic Forum
http://www.weforum.org/reports/future-long-term-investing-1

are facing in terms of liability profile, risk appetite and decision-making will not all be resolved by a new type of fund, we believe that it can make a positive contribution.

The massive size of the European retail market and evidence of retail investors' appetite for long term investments when properly incentivised (e.g. life insurance with favourable tax treatment, real estate) plead in favour of including retail investors in the target market.
Obviously as the range of investors targeted is inversely proportional to the level of investor protection required, the inclusion of retail investors might require a different type of share in the fund with additional protection.

Different types of investors might also prove complementary, having an appetite for different levels of risk and return.

b. What types of assets should be permitted?
i. Debt financing (bonds, etc.)
ii. Equity financing
iii. Indirect investments, such as funds
iv. Other forms of participations (if so, please elaborate)

Both equity and debt should be permitted, however we believe that **equity should be promoted first** as it provides several benefits:

- First given the long term nature and risks of the underlying investments an instrument offering an unlimited upside and no maturity such as equity would be far more appealing and appropriate than an instrument offering a limited upside and a fixed maturity such as bonds.
- Additionally equity would enable active exercise of fiduciary duties by countercyclical investors, reducing the pressure on management to perform short term and ensuring its commitment to a long term strategy.
- Finally the danger of excessive leverage evidenced during the crisis pleads in favour of promoting equity first.

Indirect investments in other funds can provide some added value, to the extent that the underlying funds have a specific expertise, e.g. expertise in some type of underlying, sector, geographical area etc. But we must ensure that the related multiple layers of fees remain at a reasonable and competitive level.

Other types of assets can also prove useful, provided that they do not involve a reliance on ratings, maturity transformation or leverage, as they may enable the level of risk to be fine-tuned to different types of investors.

Beyond these general remarks, the type of assets that should be permitted and promoted should be a function of the appetite and constraints of the target investors. Such an assessment should take into consideration not only current regulation and accounting standards but also necessary changes identified in these areas.

c. What types of target investments should be permitted?
i. Infrastructure investments
ii. Any investments with longer-term maturities
iii. Other kinds of targets
iv. Other combinations of investments

We believe that the target investments permitted inside this new type of fund should fulfil the three following criteria:

- Investments in sectors with long term business cycles or requiring large upfront costs and long horizons before they break even or can be sold at a fair price.
- Investments providing public benefits or positive externalities for society, such as infrastructure, hospitals, universities, energy transition and direct venture capital financing innovation.
- Investments where there is an identified current or expected funding gap.

As an example real estate should thus not be inside the scope of target investments, with the important exception of social housing, as there is no shortage of funding, as it does not provide positive externalities and as it is prone to bubbles.

d. If the longer-term investments were to be limited only to those with certain maturities, what threshold might be appropriate?
i. Only investments with a maturity +10 years
ii. Only investments with a maturity + 20 years
iii. Other possible maturity?

We do not favour a limit based on a fixed maturity threshold. We believe instead that **the maturity should derive from the choice of asset class or target investment permitted.**

Different investments such as direct venture capital, infrastructure, and private equity require different time horizons[4], and the choice of investments allowed within the scope should guide the maturity.

A second criterion should be for the time horizon to be at the very least one business cycle / project duration or longer.

If however there had to be a specific threshold, we would recommend the longer of either 10 years or the business cycle/project duration, as the focus of this new type of fund is infrastructure projects rather than other types of long term assets with a shorter average maturity like private equity.

e. If shorter-term investments were allowed to be included into the portfolio, what proportion of the portfolio should be permitted for them?

The proportion of shorter-term investments allowed to be included into the portfolio should be a function of the liquidity requirements of the fund, as per question g.

Once the appropriate liquidity / redemption rights have been defined, together with possible requirements on secondary market trading of the units, the proportion of short term investments can be derived from those factors, under cautious assumptions.

f. Should a diversification of investments be required?
i. If so, what should the minimum number of ultimate counterparties be?

In order to answer these questions, we need to define first what diversification is. **The financial crisis evidenced the failure in times of stress of “traditional” diversification between asset classes and geographical spread using implied or historical correlations**.
As a result, several types of investor are currently rethinking their asset allocation frameworks and focussing more on the fundamental drivers of risk and return rather than on asset classes.

We believe that diversification should be understood as the mutualisation of risk between different projects with different time horizons and at different stages of maturity, exposed to different types of risks and in sectors with different exposures to economic cycles.

[4] Figure 1 - The future of long term investing – World Economic Forum http://www.weforum.org/reports/future-long-term-investing-1

The large average size of infrastructure projects creates specific constraints compared to investments in securities, as it is likely to require resource pooling from several investors, and as diversification might be more difficult to achieve here than with other traditional investments.
Investing in well understood and well-priced projects is therefore even more important here than for traditional investments.

Based on a proper definition of diversification and bearing in mind the above mentioned constraints, we believe that there should be minimum diversification requirements. This would enable a mutualisation of risk and a smoothing of cash flows that would be beneficial for all stakeholders.

The minimum number of ultimate counterparties should be determined based on empirical evidence derived from the experience of traditional long term investors.

g. Should investors have redemption rights?
i. Periods less than a year
ii. Yearly
iii. Some longer set period
iv. No rights from the fund manager
v. Other approaches (e.g. relying on or requiring secondary trading of units in the fund)

We believe that investors should have redemption rights, albeit at a lower frequency than traditional investments vehicles.
The post-crisis awareness of investors and regulators of the value of liquidity has sometimes led to an excessive focus on this feature to the detriment of other key elements of an investment. This sometimes excessive focus from investors and from regulators is one of the factors constraining the ability to invest long term and as such needs to be addressed in the specific context of long term investment funds.

We would favour yearly redemption rights after a lock-in period of a few years to be determined, to reflect the fact that the underlying investments typically take time before generating their first cash flows. Also we believe that investors committing to long term investments are less likely to feel financially constrained by the lack of liquidity during the first years than at a later stage.

We believe that different redemption rights might need to be designed for retail and for institutional investors, in terms of percentage of the investment, frequency or lock-in period.

Additionally, specific design features of the redemption rights should be considered:

- The redemption rights could embed a built-in incentive mechanism proportional to the holding period and penalizing early redemptions via a gradually decreasing fee or other mechanisms.
- The date of the redemption rights should be different from dates of periodic reporting, to minimize the potential for instinctive reactions.
- The benefits of redemption gates should be examined: such gates would provide time to find new investors to replace the ones leaving. By doing so, the gates would contribute to the fund liquidity without requiring a reduction in the size of the fund and a related sale of assets.

h. If redemption rights are to be given, must additional steps be required (e.g. ensuring a liquidity buffer is available)?

Redemption rights should be used, together with other potential measures regarding secondary market liquidity, to determine the proportion of short term investments in the portfolio, as per question e.

i. Transparency requirements (e.g. possibility to "look-through")

Given the long term horizon and illiquid nature of the underlying investments, there is a great need for transparency, that will contribute positively to possible secondary market liquidity, short/medium term accountability and investor confidence.

It is however key to ensure that the transparency requirements provide the right kind of information and use appropriate metrics: among other things the information provided should be financial as well as non-financial, and the measurements used should reflect appropriately the underlying risks and long term nature of the investment.
Failure to provide and communicate on the right metrics could indeed have a detrimental impact on investors' trust and commitment and create unwelcome short term pressure on fund managers.

j. Other requirements

We believe that some work needs to be done in three areas:

- On the ***packaging of these funds*** when targeted to retail investors directly: building in incentives for long term holding, such as returns embedding a multiplier that is proportional to the holding period, could give the right incentives and make them more attractive to this target market.

- On the ***metrics used*** to measure and communicate the risk and performance of these funds: inadequate metrics have been clearly identified as one of the constraints weighing on long term investment: just as risk is not the volatility of past earnings but rather the failure of an investment to meet the reasonable cash flow expectations of savers[5], risk metrics such as the mark to market value of an asset, its value at risk, its Sharpe ratio or its performance relative to an equity benchmark are very short term oriented and pro-cyclical indicators that are clearly not adequate for long term investments. Using them would not only have a detrimental impact on the proper assessment of risk and performance but also provide the wrong incentives both for fund managers and for investors. It is therefore indispensible to design adequate risk and performance measurements that balance short term accountability with a long term perspective and use them to communicate about this new type of fund.

  Such new measurements could include non-financial information like a periodic review of the validity of the underlying assumptions and fundamentals of the project measured against the economic cycle, a tracking of the interim changes in cash flow/income from the investment, appropriate internal rates of return, absolute return or liability driven benchmarks instead of market indices, and some short term metrics but used differently to monitor trends over longer horizons, such as the moving average of asset prices.

- On the ***governance arrangements*** of these funds: ensure that performance measures and compensation structures have the proper horizons and adequate incentives (bonus clawbacks or invested in parallel portfolios etc.), promote staff stability, active exercise of fiduciary duties, official commitment throughout the organisation to long term investing, professional boards etc.

We believe that including these dimensions is key to the success of this new type of fund as it would partly address conceptual flaws and principal-agent problems currently in the way of long term investing.

[5] Cf. Kay review of equity markets – Final report http://www.bis.gov.uk/assets/BISCore/business-law/docs/K/12-917-kay-review-of-equity-markets-final-report.pdf

Lastly it is indispensible in our view to investigate ***related issues outside of the scope of this proposal*** that need to be addressed in order for these funds to be successful.
Such issues include among others regulatory and accounting constraints to long term investing, government planning of infrastructure projects and the need for tax incentives for long term investment vehicles.
Identifying these issues clearly would prepare the ground to address them through appropriate legislative proposals.

18. Which features should be defined in more detail by legislation and which should be left to contractual arrangements? Why?

For consistency purposes with UCITS in general, we believe that as a rule legislation should define for the new type of fund the same features that are currently defined within UCITS product investment rules. These include eligible assets, risk management requirements including leverage cap and use of derivative instruments, diversification requirements, liquidity requirements, and borrowing rules.

In addition legislation should define:

(i) within eligible assets, criteria on the maturity and positive externalities of the underlying investments;

(ii) the risk and performance metrics to be used;

(iii) the governance arrangements to be applied;

(iv) the packaging of these funds;

(v) strict limitations on the repackaging and transfer of risk, to avoid creating wrong incentives such as those found in the originate-to-distribute model;

(vi) after an impact assessment, possible additional disclosure requirements within the KIID highlighting the specific nature and risks of such investments.