Finance Watch contribution to the hearing on European Long Term Investment Funds
Frédéric Hache, Senior Policy Analyst, Finance Watch
Brussels, 13 November 2013

1. Before commenting on the proposed ELTIF regulation, I would like to make a few preliminary remarks looking at the broader context and at the choices underlying this proposal.

Our understanding of the Commission proposal is that the long term funding gap, combined with strained public finances and an expected decline in bank lending, led to the conclusion that we needed to promote alternative financing channels, in order to increase funding for the real economy.
While we fully support this objective, we believe that the related promotion of capital market financing and of a further privatisation of quasi-public goods is a choice that raises several questions.

2. We believe first of all that there is a qualitative difference between bank lending and capital market financing, in terms of flexibility, quality of the risk assessment and interconnectedness.
The expected decline in bank lending as a result of bank deleveraging is also not inevitable and would be the banks'choice.
We appreciate that it is not a question of either one or the other. And we welcome alternative channels of financing, especially if they contribute to a reduction in maturity transformation in the system.
However we believe that more could be done to prevent a decline in bank lending, including revisiting the overly prescriptive approach of prudential regulation that promotes asset homogeneity, and providing banks with stronger guidance on the type of activities expected of them.

3. Now why are we interested in this file as Finance Watch? There are several public interest dimensions linked to this proposal, some of which are conflicting:
First one might question whether it is desirable to further privatise the funding and operation of quasi-public goods like infrastructure? And whether the growth of private financing will interfere with their public good features and increase excludability?

Because the discussions are premised on a reasonable financial return to attract investors, these approaches are viable only to the extent that infrastructure generates revenues. Given the constraints on governments' budgets and their reluctance to further increase taxes, it is likely that user charging will become a more common policy.

This raises questions about the public willingness to pay tolls on more highways, and also about whether favouring user-fee based projects is compatible with the objective of promoting sustainable and inclusive growth.
The example of the Sydney airport where buying a duty-free item puts you into a special, speedy customs line, and where parking your car in the shade costs an extra 4 dollars provides an extreme example of what an efficient privatisation can look like.
We believe that such an important issue would benefit from a democratic debate, as it is likely to influence European citizens' lives for decades to come.

The second and related public interest dimension is the need to ensure value for money services for users, by ensuring that more private financing of quasi monopolistic assets does not lead to rent seeking situations.

Thirdly public support is expected to play a growing role in the future long term investment fund, via the use of public private partnerships, and the greater involvement of export credit agencies and institutions such as the European Investment Bank.
While we support a public involvement to stimulate private sector appetite, the many levels and forms of public support require in our view a transparent and aggregate disclosure of public involvement, to ensure democratic accountability and a fair sharing of risk and returns amongst all stakeholders.
We believe as well that public intervention should aim at stimulating private sector appetite, rather than compensating for a decline in activity linked to an overly prescriptive prudential regulation.

A fourth public interest dimension is that of retail investor protection. We believe that the proposal could go further to align the interests of asset managers and investors.
We also want to highlight that providing attractive returns to investors conflicts with the provision of value for money services for users, and we must strike the right balance for all stakeholders including users.

4. Lastly, private equity and infrastructure are already growing asset classes, in some cases with too many hunters for too few targets. Therefore we must ensure that the objective to fill the funding gap does not lead to a bubble, just as the political objective to increase home ownership contributed to the real estate bubble.

5. Regarding the ELTIF proposal itself, we strongly welcome it and are convinced that this new framework has a key role to play in providing a harmonised, transparent and sound model building on the lessons learned from past experiences.
However we would like to comment on three points:

6. First we are unsure that "not listed" is the best criteria to define long term assets. As an example there is a fairly good case for including listed equities with appropriate holding periods within the scope.
Inversely one might wonder how non-productive investments such as residential real estate contribute to the objective of growth and employment.
Real assets should also be limited to soft and hard infrastructure, as we are not quite sure about the contribution to the real economy of assets such as race horses or fine wines.

7. Secondly we welcome the cap on cash borrowing in the proposal, as excessive leverage magnifies the impact of cash flow forecasting failure on investors' returns, reduces flexibility and increases the need for insurance or credit enhancement.
However we would rather see a mandatory cap on leverage than a cap on cash borrowing, since cash borrowing is not the only way to get exposure to leverage.

8. Lastly some earlier models of funds had built-in conflicts of interests between the fund manager and the investors, including misaligned fee structures.
And recent surveys show that lack of interest alignment remains one of the key concerns of institutional investors.
We believe that these concerns are not fully addressed and that the ELTIF proposal is a great opportunity to develop an "aligned interests" framework building on the best models. This would in our view contribute to the success of this new type of fund with investors.

Possible measures could include ensuring a meaningful financial commitment of the asset manager to the fund, either a cash commitment or via the reinvestment of performance fees in the fund, depending on the structure.
They could include as well management fees based on operating expenses rather than assets under management, as excessive base fees have been known to distort investment decisions and encourage so-called "zombie funds", that is poor-performing and inactive funds that still collect fees from investors.
Performance fees should also include a meaningful threshold, be linked to the cash distributed to investors and include claw back provisions.

10. In conclusion, we believe that provided some key issues outside the scope are addressed and provided strong governance arrangements are included in the proposal, the ELTIF should achieve its objective of channeling more investments to finance the real economy.