

# Chapter 4

## Shifting to the long-term: the road ahead

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### 1. Introduction

This chapter discusses the need for and strategies supporting a shift in the investment time horizons of institutional investors towards long-term sustainable investment. Pension funds are the primary focus; because, in principle, they should have long-term time horizons (as managers of retirement savings) and secondly, should have an interest in the exercise of workers' voice in corporate governance in social and environmental matters. The potential contribution of pension funds to clean energy finance is explored as an illustration of the role pension funds could play in supporting long-term sustainable investments.

The need for institutional investors to adopt long-term investment strategies – including investment in infrastructure, clean energy and transport – has become a policy priority at the international level. A first question to address is what long-term investment means: what it is, or, alternatively what it is not. Ideally the definition should take both approaches on board: (i) the positive approach, which is ensuring that institutional investors effectively deliver 'patient, productive and engaged capital', but in a responsible way and, at the same time (ii) the negative approach, shifting away from short-termist and speculative behaviour. In practice however, the two approaches rarely coexist, which can lead to some investor schizophrenia.

A lot of attention is paid to the role of pension funds in this debate. Given their social purpose (i.e. financing workers' rights to decent retirement) and their long-term liabilities, it would make sense for pension funds to embrace a long-term investment strategy. Climate change finance provides a good example of how pension funds' potential could be unleashed. Our calculation suggests that – in a 'blue sky' world – pension funds could theoretically deliver some USD 300 billion per year in net contribution to climate change mitigation projects.

The reality is somewhat different. There are several challenges that would need to be addressed to unleash the potential of institutional investors to engage fully in long-term investment strategies. In the short term, the prolonged quantitative easing policy by central banks is negatively impacting institutional investors with long-term liabilities. The post-crisis financial reforms – as legitimate as they may be from a financial integrity and stability perspective – have had some unintended consequences as well. The problem of risk rating is also acute for financing long-term infrastructure in developing countries. Overall, policymakers need to distinguish between ‘productive’ risk (or ‘good’ risk) and ‘unproductive’ risk (or speculative risk) when setting or reviewing financial prudential norms.

There are many structural barriers as well: there is a lack of marketable products and of standardised reporting requirements, including environmental, social and governance impact, that meet long-term investment criteria. Importantly, asset owners should exercise strong leadership to hold asset managers to account, which they currently for the most part do not do. The multiplication of intermediaries along the investment chain is creating major complications for asset owners who wish to ensure proper accountability of how their funds are being invested. Finally, the level of concentration of the financial sector and the role taken by large financial conglomerates that are ‘too-big-to-fail’ may also create structural challenges to asset management accountability and hence to long-term investment strategies.

Assuming that all the above requirements for an effective policy and regulatory road to long-term investment would come into effect: would that still be a desirable outcome? Could the costs outweigh the benefits when it comes to the public purse and to public services? These are key questions.

## **2. What it is, what it is not**

The need for institutional investors to adopt long-term investment (hereafter LTI) strategies and in particular to increase portfolio ‘exposure’ to infrastructure projects, including clean energy and transport, has become a central policy priority at the international level. At its meeting in St Petersburg on 5-6 September 2013 the G20 endorsed a work plan (OECD 2013a) as well as new High-Level Principles of Long-Term

Investment Financing by Institutional Investors (OECD 2013c). The Principles were drafted by the OECD and followed on extensive work by the OECD Secretariat (2011c; 2013c). In the run-up to the summit, the Financial Stability Board (FSB, the forum through which G20 commitments on financial reform are to be implemented) released a series of reports on the ‘financial regulatory factors affecting the availability of long-term financing’ (FSB 2013a; 2013b). Promoting long-term investment strategies is on the radar screen of other key forums such as the European Commission (EC 2013) (see here the contribution by Johnston and Morrow to this volume).

A first question to address is what LTI means. In what follows we suggest two approaches: a positive list (what it is) and a negative list approach (what it is not).

## 2.1 A positive list approach

The FSB defines LTI as any financial asset which has a maturity exceeding five years and is invested in the productive capacity of the economy (including infrastructure, software, R&D, housing, oil, gas and energy). The rationale of the FSB is that institutional investors (in contrast with banks) ‘will need to assume a greater role in this market’, given ‘strains on government budgets and the weakened banking system’ (FSB 2013a: 2). As such the LTI concept is treated as a response to a post-crisis structural shift from a bank-centred Continental European and Japanese intermediated model of financing of the economy (i.e. corporate loans) toward an Anglo-American style dis-intermediated market-centred system (i.e. corporate bonds).

The FSB definition links LTI to productive capacity of the economy – which is welcome – but it sets an arbitrary horizon for what long-term is (five years) and importantly, it sets that horizon from the perspective of the asset being traded, not the holding period by the investors. In the extreme, a share traded and held less than five minutes on the market could qualify according to the FSB definition, since equity a priori has an infinite perspective.

A more qualitative approach prevails at the OECD. It defines LTI as ‘patient, productive and engaged capital’, that is:

- patient capital allows investors to access illiquidity premia, lowers turnover, encourages less pro-cyclical investment strategies and therefore higher net investment rate of returns and greater financial stability;
- engaged capital encourages active voting policies, leading to better corporate governance;
- productive capital provides support for infrastructure development, green growth initiatives, SME finance etc., leading to sustainable growth (OECD 2013d).

The OECD definition is superior to the FSB definition. Like the FSB, the OECD links LTI to the real economy ('productive capital'). However its concept of 'patient capital' is not defined by the maturity of the asset, but by the holding period of the investor ('access illiquidity premia'). Importantly, it adds the 'engaged capital' as a central dimension of LTI, hence stressing the importance of governance and transparency along the 'investment chain' – from asset owners, to asset managers, down to the board of invested companies.

While the OECD definition is a welcome one, it does not elaborate further on the conditions for productive capital to lead to 'sustainable growth'. In particular there is nothing that would suggest in the OECD approach that environmental, social and governance (ESG) criteria should be taken on board, and indeed mainstreamed in the investment policy of institutional investors and in the reporting framework of asset managers and of invested companies.

## 2.2 A negative list approach

An alternative approach consists in defining LTI by what it is not. According to this approach LTI is needed in response to the concerns around the externality costs of short-termist and/or speculative behaviour by financial players. LTI then is considered less as a pro-active solution – financing the real economy – and more as a re-active solution to the growing financialisation of the economy. This approach – and one that is much favoured by international labour groups (Epstein and Habbard 2011) – requires some acceptable definition of terms like 'short termism', 'financial speculation' and 'financialisation' which can indeed be challenging.

The concept of short-termism for instance is most often associated with executive remuneration policy that harms the long-run interest of the company, leading to corporate decisions that are led by immediate financial gains (short-term share price gains, excessive dividend policies, share buyback programmes, layoffs in profitable activities, ‘fascination’ of CEOs for takeovers, listings or LBOs) rather than by real economic objectives (such as increasing market share, technology and innovation). It is also strongly associated with Anglo-American forms of capitalism. In practice however it can take different forms country by country, and the idea that short-termism is fuelled only by Anglo-American shareholder value models might be simplistic and misleading. Continental European and Japanese financial and governance models have had their own limitations in ensuring that companies adopt long-term strategies, as evidenced by recurrent problems with related party transactions when the company’s assets are diverted to serve the interests of the controlling shareholder.

Ideally, LTI should be defined taking both approaches on board: (i) ensuring that institutional investors effectively deliver ‘patient, productive and engaged capital’ (as the OECD puts it), but in a responsible way (as civil society and labour groups would add) and at the same time, (ii) shift away from short-termist and speculative behaviour. In practice however, the two approaches rarely coexist, which can lead to some schizophrenia, such as a given institutional investor financing projects and infrastructure with a clear long-term sustainability goal and at, the other end of the portfolio, increasing exposure to hedge funds and high frequency trading. At intergovernmental level, words like speculation and short-termism are still not acceptable terms. To give a practical example, during the round of negotiations that took place at the OECD regarding the above mentioned OECD/G20 Principles, the last part of the sentence ‘taking a long-term view also allows investors to appraise and benefit from the fundamental value of their investments, rather than be guided by short-term speculation’ was deleted in the final version that was made public at the St Petersburg summit in September 2013.

## 2.3 The central role of pension funds

Institutional investors can be divided into two groups: asset owners (pension funds, insurance companies, sovereign wealth funds) and asset managers (asset management firms and bank asset management branches). In the discussion on LTI, it is important to focus on the role

of asset owners, because they are the ultimate owners of assets and because their liabilities are long-term by definition.

This is particularly true for pension funds, whose liabilities can span over 20-30 years (i.e. the time needed to accumulate capital to finance workers' right to retirement). With over USD 30 trillion assets under management – of which 90 per cent are managed in developed economies – pension funds represent an important class of asset owners. Importantly, they have a social purpose, that of financing workers' right to retirement, and most often they are established as part of a collective bargaining agreement and include member-nominated representatives on their board of directors. Given their social purpose, it would only make sense for pension funds to embrace fully both negative and positive list approaches to LTI, i.e. shifting away from short-term to long-term investments, mainstreaming responsible investment practices and increasing portfolio exposure to infrastructure and job creation projects.

The pension funds that are market leaders in engaging in LTI and responsible investment strategies are all established under sector-wide collective agreements between employers and trade unions, most often as (pro-worker) 'defined benefit' schemes. There are only a handful of defined contribution schemes (favoured by employer groups) in the top ranking of pension funds investing in infrastructure (OECD 2013a: 32). In the case of clean energy investment, pension leaders include Danish PensionDenmark, ATP, US CalPERS and CalSTRS, Dutch ABP and PGGM, Swedish APs and several industry funds in Australia. The decision in April 2012 by the South African Government Employees Pension Fund – another pension fund with strong union representation on its board – to invest R 1 billion in green bonds is another example hereof.<sup>1</sup>

### **3. The case of clean energy finance**

The case of pension fund investment in climate change-related assets provides a good example of how investors' potential could be unleashed for LTI. Irrespective of its sustainability objective, the long-term horizon of climate change finance happens to match the liability profile of pension funds. In theory it fits very well with pension funds' long-term strategy.

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1. Government pension fund invests R1bn in 'green bond' – 8 April 2012 [www.eprop.co.za](http://www.eprop.co.za)

In reality, however, pension funds' exposure to climate change is limited today. Or rather the current share of pension fund investments in climate change financing is open to debate to the extent that it is largely dependent on how one defines such investment, both in terms of objective – increasing environmental 'efficiency', increasing renewable energy, reducing greenhouse gas (GHG) emissions – and of asset classes – listed equity, bonds and investment funds.

At one end of the spectrum, a strict definition of climate change projects would limit the scope to 'clean' (renewable) energy private equity infrastructure funds. Under that definition, the current contribution of pension funds is very marginal. The share of clean energy infrastructure in the largest pension funds (i.e. those that are the current leaders) is typically around 0.3 - 0.5 per cent of total portfolio. Access to precise data is problematic. Current pension regulation does not require pension funds to report asset allocation in a sufficiently detailed manner so as to identify the exact share of portfolio invested in infrastructure funds. At OECD level, these are lumped together with other alternative classes under the category 'other'.

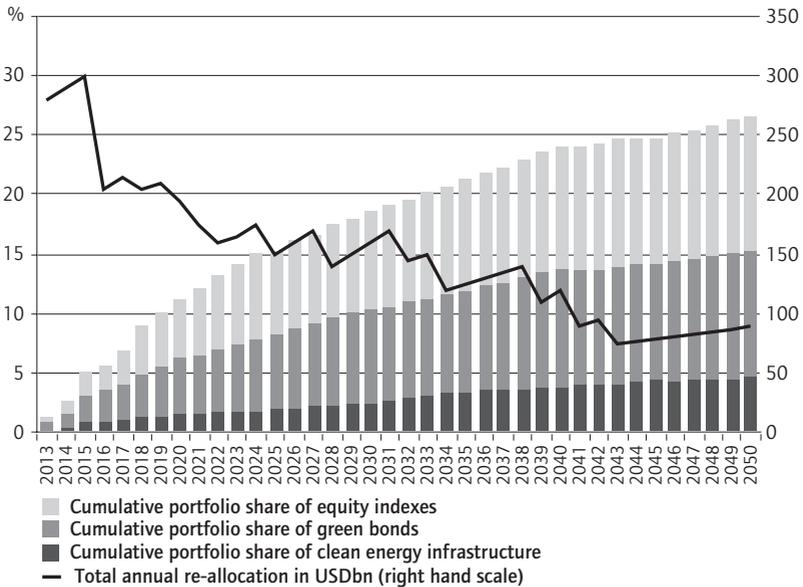
At the other end of the spectrum, a wide definition would include the 'sustainability' equity indices, such as the Dow Jones Sustainability Index, in which case the share of pension funds' portfolio in climate change might be well above ten per cent. But not all sustainability indices are climate change specific. Some are, because they are based on a positive list approach in which selection is limited to companies specialised in clean energy technology. Other indices select companies above a threshold of revenues generated by clean energy activities (say 30 per cent). But many other indices – and the largest and most accessible one for investors in particular – have a process-based approach, looking at 'best practices', risk management, and reduction in GHG emissions. Large multinational oil companies – such as BP, Chevron and Total – feature prominently in these indices.

Green bonds stand in between private funds and equity indices in the range of climate change related assets and are the most promising source of investment from a pension fund perspective. The fixed-income asset class, to which listed bonds belong, constitutes the preferred asset of pension funds (and of their regulators). Like 'traditional' bonds, green bonds can be issued by a variety of institutions: private corporations, governments and international agencies, or financial institutions (when

the green bond takes the form of a structured product, such as a collateral debt obligation).

As shown in the Annex to this chapter and in the chart below, and based on previous trade union work (ITUC and TUAC 2012) and OECD research (Della Croce *et al.* 2011), it would be theoretically possible to raise pension funds’ investment in climate change-related assets to reach five per cent of their total portfolio in a three year period, thereby generating some USD 300 billion in annual flows in these three first years.

Figure 1 Theoretical projections of pension funds cumulative exposure to climate finance



Source: ITUC & TUAC (2012).

#### 4. The road to long-term investment

The above estimates are broad and could be fine-tuned of course. They nevertheless give an indication of the potential contribution of pension funds to climate change financing – the demand side – in a ‘blue sky’ world in which there would be no barriers or restrictions to LTI on the supply side. The reality is somewhat different. There are several

challenges and barriers that would need to be addressed and overcome to ‘unleash’ the financial potential of institutional investors to engage fully in LTI strategies.

#### 4.1 Overcoming the crisis and... the monetary policy response to the crisis

The first barrier, in the short term, is the current economic crisis. Pension funds have been hit hard by the 2008 market crash and the financial instability that followed. By the end of 2010, pension funds in OECD countries had recovered USD 3 trillion from the USD 3.4 trillion in market value that they lost in 2008. The three year average pension fund annual real (i.e. inflation adjusted) return over 2008-2010 has been -1.4 per cent across the OECD. More than five years into the crisis, many pension funds in the OECD are still struggling to meet minimum funding levels (i.e. having sufficient assets under management to match future pension liabilities). The top priority for pension fund managers is to regain funding sustainability. Such an objective does not necessarily conflict or compete with LTI. But the crisis still is a primary concern for the time being. Given the inherent risks associated with developing new investment products and strategies, pension managers might be reluctant to accept investing, or increasing exposure in any asset classes that may put at risk their current compliance with regulated funding rules to meet long-term liabilities.

The prolonged ‘quantitative easing’ programme by central banks is also having unintended consequences on institutional investors with long-term liabilities. Since long interest rates are normally higher than short-term rates, the low interest rate environment and the flattening of the interest rate yield curve is a good thing for banks because they are highly dependent on short-term funding. It is a bad one however for insurance companies and for pension funds which have no short-term liabilities and, in contrast to banks, are very sensitive to long-term rates. This sensitivity occurs not only on the asset side, because of returns on investment, but also on liability side, since the valuation of pension liabilities is inversely proportional to interest rates. Quantitative easing and the resulting low interest rate environment may then in turn push investors into a ‘search for yield’, increasing exposure to high return, high risk assets, including, as the OECD (Antolin *et al.* 2011) puts it, ‘gambling’ investment strategies. The ultimate dangers of investors desperately

looking for yield is the mispricing of risk and assets and the creation of another round of speculative bubbles, as happened in 2007-2008.

## 4.2 Policy and regulatory coherence

Barriers to LTI also relate to inconsistent policy frameworks. The most obvious case of lack of policy coherence is clean energy. As long as policymakers let fossil fuel subsidies co-exist with pro-active clean energy policy, there is little chance that investors will trust and have confidence in meaningful, stable and predictable prices on carbon emissions, and hence on the comparative financial returns of clean energy. Policy coherence in the broad sense would also require governments to 'lead by example' by influencing practices that via state ownership and public procurement programmes can help move toward LTI.

Policy coherence also extends to financial regulation. The post-crisis wave of financial reforms that started with the G20 summit in London in April 2009 – as legitimate as they may be from a financial integrity and stability perspective – may have had some unintended consequences on investors' capacity to shift toward a stronger LTI strategy. The need to limit both risk taking behaviours and leverage levels in the financial sector – as aimed for, for good reason, by several financial reforms – could indeed hamper the capacity of institutional investors to re-allocate money to LTI-oriented assets. This is particularly true for pension funds. Because they aim at financing a social purpose – workers' right to retirement – they cannot take excessive risks in the choice and design of their investment policy. Yet LTI projects such as infrastructure and climate change mitigation may entail a higher level of risk than comparable non-LTI, non-infrastructure or non-climate related investments. These risks result from the use of recent or unproven technologies, uncertainty and inconsistency of regulations and policies as well as cross-border investment risks.

Another example is given by the generalisation of mark-to-market accounting rules in the valuation of liabilities, gains and losses, in contrast with alternative methods that allow 'smoothing' over a given period and/or that reflect the underlying performance of assets and investments, rather than the market price on a given day. Mark-to-market has the merit of instant transparency and, by definition, can be subject to differing interpretation. But it may create volatility in the calculation of liabilities

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and assets on the balance sheet of investors – in particular of pension funds (Severinson and Yermo 2012). When combined with relatively short-term information from asset managers, mark-to-market accounting can make it difficult for institutional investor to focus on LTI.

The problem of risk rating is also acute for financing long-term infrastructure in developing countries. Many developing countries have no sovereign rating, despite the fact that the existence of such a rating is a pre-requisite for foreign investors. According to a report commissioned by the G20, in 2012 nearly 77 per cent of the 35 Low Income countries (mainly in Africa) and 55 per cent of the 56 Medium Income Countries are still not graded by any rating agency. While 75 per cent of the 52 Upper Income Countries are graded, just 37 per cent are rated ‘investment grade’ (Roland Berger 2012). The report further highlights the lack of financial information for private infrastructure projects, since grades are not required. As a result, potential private investors have been basing their risk assessment only on sovereign risk, even though some business sectors are independent from this sovereign risk. Lack of information and the ‘disconnect’ between sovereign risk captured by the financial markets and the effective ‘business risk’ in LICs and Lower MICs leads to lower levels of funding and higher costs of financing than would apply otherwise.

The concerns about the unintended consequences of post-crisis financing have been exploited, if not manipulated by opponents to reforms. Bankers in particular have raised this concern and surely have exaggerated it to oppose the new Basel III prudential framework, which sets higher standards for banks for capital requirements and leverage. Yet the potential risk for short- and medium-term financial stability and LTI objectives to clash should not be brushed aside. Regulators need to be able to distinguish between ‘productive risk’ (or ‘good risk’) and ‘unproductive’ or speculative risk, when setting or reviewing financial prudential norms for institutional investors, banks and insurance groups and funding rules for pension funds. Making such a distinction is possible in theory (Lazonick and Mazzucato 2012) but it has not yet been done in practice at government and policymaker level.

### 4.3 Financial products and reporting standards

A further barrier is the lack of marketable products that meet LTI criteria to fulfil the scale and liquidity requirements for institutional investors to

shift strategy: transparent products that can combine performance, security, transparency and traceability of investment into LTI projects, such as low-carbon projects or long-term infrastructure.

Here too the lack of climate change investment products is a case in point. The current green bond market value (i.e. the stock) is estimated at USD 16 billion. For the OECD (Della Croce *et al.* 2011) this is ‘a drop in the ocean’ of the USD +95 trillion value of world bond markets, while annual green bond issuances (i.e. the net inflows) are in the range of USD 1-2 billion (compared with some USD 6 trillion worth of issuances of ‘normal’ bonds). The availability of insurance products, including standardised and non-standardised derivative products to help manage and mitigate risks that are specific to LTI projects, would also needed to be enhanced, if they are to be properly regulated and supervised by authorities. This is not yet the case, as the recurrent delays in the reform of the over-the-counter derivatives markets has shown.

Further down the investment chain, it would also be appropriate for issuers (i.e. listed or private companies) to observe common long-term reporting requirements and to disclose and report on environmental, social and governance (ESG) performance and impact, making sure that the right information is available to investors regarding responsible LTI. We are still far away from mainstreaming ESG reporting. The prospect of ‘integrated reporting’ as promoted by the Global Reporting Initiative would help put ESG reporting on equal footing with financial reporting when considering the company’s risk management and risk reporting framework.

#### 4.4 Leadership by asset owners and accountability of asset managers

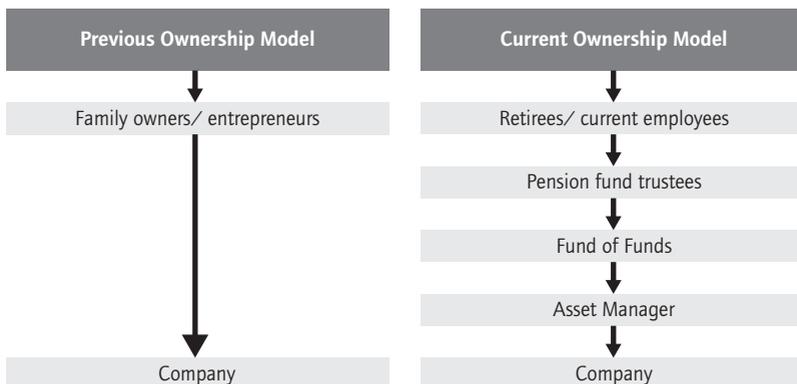
Asset owners should exercise strong leadership to hold asset managers to account. This is needed because asset managers may have vested interests that are not aligned with those of their clients. Yet, asset owners are not visible in the policy debate on the structural shortage of long-term capital (White 2013). In the case of pension funds, leadership requires board independence that prevents conflicts of interest with asset managers and other financial service providers. That in turn requires accountability to members of pension schemes through member-nominated trustees. It is no coincidence that all pension fund leaders in

investing in clean energy have pension member and worker representatives on their boards.

Beyond board independence, asset owner leadership also needs to translate into board confidence in the merits of shifting further toward responsible LTI. That confidence can be achieved by ensuring that the legal framework for fiduciary duties does not constitute a barrier to responsible LTI. This relates to an old debate on the definition of the fiduciary duties and the extent to which it allows for long-term non-financial material risks – environmental, social, human right risks – to be explicitly taken on board.

Another reason for the lack of asset ownership leadership is the decade-long lengthening of the 'investment chain'. The traditional ownership model – an asset owner and an owned asset – is no longer relevant. The multiplication of intermediaries (asset managers and the many associated consultancies) is creating major complications for asset owners who wish to ensure proper accountability of how their funds are being invested. A lot of recent literature points out to these problems, not least in the UK (Kay Review 2012) (see on this issue also the chapter by Williamson in this volume).

Figure 2 The lengthening of the investment chain



Source: Della Croce *et al.* (2011).

What needs to be done? For a start, the contract that binds the asset manager to the asset owner, including remuneration and extension of contract clauses, should encourage the asset manager to take a long-term

view of portfolio performance. Such long-term metrics should naturally tone down the importance of quarterly (three month) performance benchmarks. That is rarely the case, and it is only recently emerging as a best practice. Achieving this is even harder when the bargaining power tilts in favour of the asset manager or when there is no transparency for asset managers' fees and remuneration structures and other related costs and charges.

Setting robust contractual standards is also needed to ensure that ownership rights that asset managers 'hold' on behalf of asset owners (including shareholder voting rights) are effectively exercised. Disclosure of institutional investors' voting policy and the exercise of voting rights by asset managers should be mandatory, yet there too regulation is lagging behind in several OECD countries.

Shareholders' rights should have some meaningful impact on the CEO and the board of directors, including the right to propose resolutions for the agenda of the annual general meeting. But these rights need to reward, not harm those who act in the long-term interests of the company and penalise those seeking quick gains. Enhancing shareholder rights is a double-edged sword. They can be exercised in a responsible manner – ensuring board accountability and preventing management entrenchment to achieve LTI strategies – but surely they can also be used to further short-termist and speculative goals – as is the case of activist hedge funds engaging in 'rampant takeovers'.

The challenge for regulators is to avoid the two objectives of 1) promoting shareholder rights for LTI and 2) curbing those same rights to prevent speculative behaviours from happening, from becoming mutually exclusive. The two track approach to LTI – positive and negative list – clearly applies in that case. In a positive list approach, some countries grant additional voting rights to long-term shareholders (e.g. those that hold shares for a certain minimum period of time, such as one year). But rather than rewarding long-term ownership, proponents of a negative list approach to LTI might argue that much could be done to penalise short-term, speculative behaviour, such as share lending and the use of derivatives to hide real share ownership.

## 4.5 Financial sector concentration

Finally, the level of concentration of the financial sector may also create structural challenges to asset management accountability. As shown in table 1, the majority of the world's largest asset management companies are subsidiaries of global financial conglomerates that cumulate several banking and/or insurance services and are considered 'too-big-to-fail' by the G20 and the Financial Stability Board (e.g. Goldman Sachs, Morgan Stanley, JPMorgan, Société Générale, Deutsche Bank, UBS, HSBC, etc.) and of global insurance companies (e.g. Allianz, Prudential, AXA, etc.). When that happens, there is a risk of conflict of interest: the asset management branch may be inclined not to exercise shareholder rights that it holds on behalf of its clients, if the outcome could be seen as hostile by the CEO and management of the invested company and hence could threaten business relationships with other subsidiaries of the conglomerate.

Greater transparency of group-wide business relationships and strict rules to prevent conflicts of interest, such as 'Chinese walls' shielding the asset management subsidiary from undue pressure and influence from the group headquarters, can help of course. But one may well believe that, since the risk of conflicts of interest is structural – i.e. inherent to the business model of conglomerates that are too-big-to-fail – the definitive solution must be structural as well. In turn, this brings new light to the on-going, but yet controversial, policy debate on the need to force the dismantlement of too-big-to-fail groups by legally separating retail commercial banking from speculative and volatile investment and trading activities.

## 5. But do we really want this to happen?

Assuming that all the above requirements for an effective policy and regulatory road to LTI would come into effect, one may still question whether the entire LTI agenda could backlash and have unintended consequences for other parallel policy agendas. Is achieving a full LTI agenda a desirable outcome in the end? Could the costs outweigh the benefits? In what follows we discuss two areas of potential concerns: when the public purse is solicited and when public service and public administration capacities are being pressured.

Table 1 World's largest asset managers in 2010

Indicative ranking	Location of the HQ	Parent company	AUM range USDbn
Blackrock (incl. Barclays GI)	US		3500
Pimco& Allianz GI	US	Insurer	1900
State Street GA	US	Bank (G-SIFI)	1900
Franklin Templeton	US		1500
Fidelity Investments	US		1500
Vanguard	US		1400
JPMorgan AM	US	Bank (G-SIFI)	1300
Bank of NY Mellon	US	Bank (G-SIFI)	1000
Amundi (owned by Société Générale & Crédit Agricole)	France	Bank (G-SIFI)	880
Goldman Sachs AM	US	Bank (G-SIFI)	880
Morgan Stanley	US	Bank (G-SIFI)	800
Deutsche Bank (incl Henderson & Standard Life AM)	Germany	Bank (G-SIFI)	730
BNP Paribas Investment Partners	France	Bank (G-SIFI)	690
Legg Mason (incl Western AM)	US		690
Natixis AM (incl Loomis Sayles)	France		680
AXA IM	France	Insurer	650
UBS AM	Switzerland	Bank (G-SIFI)	600
Legal & General Investment	UK	Bank (G-SIFI)	580
Prudential Financial Inc.	US		540
Credit Suisse AM	Switzerland	Bank (G-SIFI)	440
HSBC AM	UK	Bank (G-SIFI)	410
Wells Fargo AM	US	Bank (G-SIFI)	370
M&G Investments (owned by Prudential Plc)	UK	Insurer	300
Kokusai AM (owned by Mitsubishi UFJ)	Japan	Bank (G-SIFI)	n.a

Source: Habbard (2012).

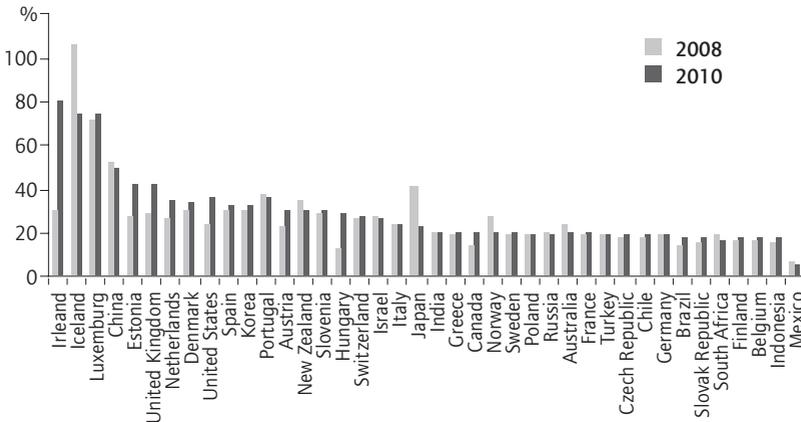
## 5.1 The risk of privatising gains and socialising losses

In the short and medium term, considering the regulatory challenges ahead and the time for transition to an LT-friendly environment to take place, government support is needed. The most common form of support is a government guarantee on the credit default risk of an asset. For example, with a few notable exceptions, all 'green' bond issuances to date have been accompanied by explicit guarantees by governments, regional development banks or the World Bank. Such a guarantee allows a green bond to be rated 'AAA' (and hence be eligible for purchase by regulated

investors such as pension funds), whereas its stand-alone rating would have been closer to a BBB rating, which is too low for many regulated investors. Government support for LTI financing can take other forms however: subsidised low-interest direct loans, export credit insurance and facilities, foreign exchange risk insurance and subsidised support services for investment deals. State-funded/run venture capital funds can also take ‘first equity loss’ positions in private investment deals.

There are good reasons to support and indeed expand government guarantees to help increase private financial flows to LTI. However, past experience with the post-2008 bailing out of crisis-hit banks shows that government guarantees are a delicate policy issue. As evidenced by OECD experts and shown in the graph below, government guarantees and other forms of contingent liabilities are equivalent to 20-30 per cent GDP for most OECD economies and have grown substantially between 2008 and 2010. The underlying issue is whether these massive public guarantees benefiting bankers have in effect transformed the entire industry into a publicly subsidised business. Andrew Haldane (2010) of the Bank England estimates that the explicit and ‘implicit’ public guarantees represented a net saving of some USD 160 billion in 2009 for 13 banks in the UK alone. The Swedish central bank (RIKSBANK 2011) estimates that the average yearly reduction in funding costs for the four largest Swedish banks amounts to some USD 4.5 billion.

Figure 3 The rise of contingent liabilities as a percent of GDP across G20 economies, 2008-2010



Source: ITUC & TUAC (2012).

Public support to private finance does not come free. It needs to be priced appropriately. Fair and transparent risk-sharing arrangements should prevail whenever public money is used to support private projects. This is needed to protect the public interest (i.e. to avoid ‘privatising gains and socialising losses’) but also to avoid unfair competition in the financial sector. Importantly, the need for ‘leveraging’ private finance should not be mixed with, or transformed into some unconditional subsidisation of bankers and of asset managers, and/or situations in which profits and gains are privatised, while deficits and losses are socialised.

## 5.2 The need to protect public services

The second area of concern is with the risk posed by LTI to the much needed protection and development of public services and public administration capacities. Mobilising institutional investors for financing infrastructure could for example end up in substituting (or ‘crowding out’) publicly controlled and financed investments and the promotion of public services, particularly in developing countries.

In many cases mobilisation of institutional investors would involve promotion of Public-Private Partnerships (PPP). PPPs account for less than 15 per cent of the total asset value of public sector infrastructure investments in countries that are considered as leaders in promoting PPPs, such as South Korea and Australia, and for less than five per cent in Canada, Germany, Italy, South Africa, Norway and Spain (OECD 2013b). But PPPs are becoming more important and feature prominently on the LTI-related global agenda. The suggestion that PPP should be considered as a preferred option for financing infrastructure relative to traditional public procurement does not hold in our view. In practice, PPPs have proven to be a flawed model that can lead to over-priced public services as well as to situations where gains are privatised and losses are socialised. In contrast to traditional public procurement, PPPs have many hidden costs and have excessively complex contracts for governments to handle (TUAC 2010).

Best practice for testing the extent to which risk-sharing arrangements under a PPP project are in line with the public interest consists in always applying a ‘public sector comparator’, that is: comparing the costs and benefits of a given PPP project with the alternative solution of public sector procurement. And where PPPs should indeed be considered in

their own right, the projects should be based on a thorough analysis of real needs, appropriateness on the longer term, fair risk sharing for the community and accessibility and affordability of the services and goods produced. They should genuinely respect a multi-stakeholder approach.

## **6. Conclusion**

The road to shifting institutional investors toward a long-term investment strategy may at first sight appear to be a massive highway. The barriers to long-term investment as well as the incentives for short-term speculation have been identified in this and other chapters in this volume.

However, a shift towards increased long-term investment by institutional investors makes sense from a stakeholder point of view because of their long-term liability profile, particularly of pension funds, but also because it would help divert investors away from short-termist speculative behaviour and promote macroeconomic stability. But there are many caveats. The crucial challenge is to restore accountability along the investment chain, and to rebalance the power relationship between asset owners and asset managers, in conjunction with strong reporting requirements. Long-term investment is a policy priority, but some inconsistencies remain. In defining LTI, the emphasis should be on the investor's holding period, as in the OECD definition, rather than the asset's maturity.

Regulatory and macroeconomic factors pose challenges as well. Financial regulation and prudential norms should to the greatest extent possible distinguish between 'good' and 'bad' forms of risk, in order to facilitate the supply of quality, long-term investment. Post-financial crisis regulatory tightening, though necessary, has had some unintended consequences on the supply of LTI. Quantitative easing and reporting standards, in particular, have contributed to low interest rates and incentives for short-term behaviour.

Moving forward, pension funds should keep in mind their central role as asset owners and stewards of workers' capital. The example of clean energy finance has shown the potential of investors, especially pension funds built on collective bargaining, to provide sustainable, long-term financing.

Yet from a progressive perspective which is shared by the labour movement and civil society groups, there are crossroads on the road ahead, including the protection of public services and of strong and efficient public administrations. We should avoid a zero-sum situation at all cost; any long-term investment agenda should add-on to, not substitute for citizens' right to public services and to effective government institutions.

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## **Annex: Calculating pension funds' theoretical potential to finance climate change-related projects**

What is the financial potential of pension funds to increase, in a reasonable way, their exposure to climate change projects?<sup>2</sup> Based on previous trade union work (ITUC and TUAC 2012a) and OECD research (Della Croce *et al.* 2011) we can make a broad estimate. To do that we first need to select a global pool of pension funds that is most likely to have the ability to invest in climate change financing:

- The total market value of assets under management by occupational pension funds worldwide at the end of 2010 was estimated at USD 19.3 trillion, or USD 27 trillion if one adds public pension reserve funds. But not all pension funds will be able to engage in climate change financing for various reasons. The decisive factor seems to be size: large schemes can invest in climate

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2. This annex is based on scenarios developed in 2013.

change investments, whereas smaller ones cannot. Unfortunately a size indicator is not readily available at global level.

- As a proxy indicator for pension size we use the share of defined benefit (DB) schemes. Because they are often established as part of collective bargaining agreements DB schemes are most likely to be large in size.<sup>3</sup> According to Towers Watson, DB schemes account for 56 per cent of total assets under management worldwide, i.e. about USD 10.87 trillion.
- Regarding public pension reserve funds, we select all the funds because they are large in size by definition. We do however exclude the US Social Security Trust Fund because by law it is required to invest 100 per cent of its portfolio in US Treasury bonds, and hence will very unlikely invest in anything else.

When combining the occupational DB funds (USD 10.87 trillion) and the (non-US) public pension reserve funds (USD 5.17 trillion) we obtain a pension fund universe that potentially could contribute to climate change financing of USD 15.98 trillion assets under management. With that pension universe in mind, we then make the following assumptions:

- Current pension fund investments and exposure (i.e. current share and future commitments) are below one per cent, hence leaving considerable room for increase before exposure becomes problematic from a risk diversification perspective;
- Total portfolio grows by +2.0 per cent annually in 2012-2017, +2.2 per cent in 2018-2030 and +1.9 per cent in 2031-2050. These figures correspond to the OECD (2012) assumptions about real GDP growth. They should be conservative enough to factor in the current global economic crisis and its long-term impact, and considering that past global pension annual asset growth was +4.6 per cent between 2005 and 2010 (+4.3 per cent for the US pension funds).
- The above projection is a reasonable one if – and that is a big if! – no systemic event takes place during the period. Such an event

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3. This is however not always the case: DC schemes in Australia for example, are large and concentrated and would certainly have the ability to invest in climate change-related products.

could be a financial crisis on the scale of 2008 combined with a demographic shock in the ageing OECD societies, which would occur on such a scale that pension schemes are forced to heavily divest in order to face exploding pension liabilities.

Based on these assumptions, we then can construct three scenarios for raising pension fund exposure to climate change financing:

- An annual portfolio re-allocation to clean energy infrastructure funds of +0.2 per cent between 2013 and 2027 and +0.1 per cent between 2028 and 2050. This is a conservative hypothesis considering that the current exposure of pension funds to clean energy funds is extremely low and that over the period the cumulative exposure would remain below five per cent (4.3 per cent in 2050), which would be consistent with prudential funding rules. Some pension funds might be able to scale up their private investments more rapidly. But we should bear in mind that climate change-related investments will to a great extent take place in emerging and in developing economies – which is far away from the home base of the vast majority of the pension funds (90 per cent being located within the OECD). Geographic distance (and the regulatory and currency risks that go with it) adds to other structural barriers that are specific to private funds such as illiquidity and transaction costs (e.g. contract negotiations and access to expertise).
- An annual portfolio re-allocation to green bonds of +0.75 per cent for 2013-2015, +0.5 per cent for 2016-2019, +0.4 per cent for 2020-2023, +0.3 per cent for 2024-2030, +0.2 per cent for 2031-2040 and +0.1 per cent for 2040-2050. This is also assumed to be a reasonable projection given the popularity of fixed income investments among pension funds and the need to ensure that the cumulative exposure (reaching 11 per cent in 2050) remains within prudential norms. This is a realistic projection as long as supply side bottlenecks are rapidly resolved.
- An annual portfolio re-allocation to climate change-related equity indices of +0.75 per cent for 2013-2015, +0.5 per cent for 2016-2020, +0.4 per cent for 2021-2026, +0.3 per cent for 2027-2032, +0.2 per cent for 2033-2037, +0.1 per cent for 2038-2042 and +0.05 per cent for 2043-2050. There too, the projection would not be too demanding for pension funds, and the annual re-allocation

would gradually decrease to take into account prudential norms (total exposure reaching 10.9 per cent in 2050). But here too supply side problems exist, and are arguably on a greater scale than for green bonds, given that equity indices that are ‘truly’ climate change-related are few (in contrast with broader ‘sustainability’ indices).

In turn this leads us to three alternative scenarios, each with a different combination of the above hypotheses.

Table 2 Assumptions underlying three scenarios for climate-change financing

Annual shift in the portfolio 2013-2050	Scenario I	Scenario II	Scenario III
From +0.2% to +0.1% to clean energy infrastructure funds			
From +0.5% to +0.1% to green bonds			
From +1% to +0.1% to climate change equity indices			

Table 3 Three scenarios for pension fund exposure to climate-change financing

Year	Scenario I	Exposure	Scenario II	Exposure	Scenario III	Exposure
2013	34	0.2%	161	1.0%	289	1.7%
2014	35	0.4%	165	1.9%	295	3.4%
2015	35	0.6%	168	2.9%	301	5.1%
2016	35	0.8%	126	3.6%	217	6.3%
2017	37	1.0%	129	4.3%	221	7.5%
2018	19	1.1%	113	4.9%	207	8.6%
2019	19	1.2%	116	5.5%	212	9.7%
2020	20	1.3%	98	6.0%	197	10.7%
2025	22	1.8%	88	8.3%	176	15.0%
2030	24	2.3%	98	10.3%	171	18.6%
2035	27	2.8%	81	11.8%	134	21.3%
2040	30	3.3%	89	13.3%	118	23.5%
2045	32	3.8%	65	14.3%	81	24.9%
2050	36	4.3%	71	15.3%	89	26.1%
Annual average 2021-2030	22		95		175	
Annual average 3031-2040	27		82		132	
Annual average 2041-2050	33		66		85	
Total 2013-2030 period	457		2028		3684	
Total 2013-2050 period	1514		3499		5856	

In terms of net annual contribution, our projections show that:

- Under scenario I (clean energy infrastructure funds only) some USD 34 billion could be re-allocated to infrastructure and private equity funds in 2013 and then fluctuate around USD 22-33 billion until 2050. The total investment flows would reach USD 457 billion between 2013 and 2030 and USD 1514 billion between 2013 and 2050.
- Under scenario II (clean energy infrastructure funds + green bonds) USD 161 billion could be re-allocated in 2013 (USD 34 billion to private funds + USD 127 billion to green bonds); allocations would then gradually decrease to some USD 100 billion in 2020, and fluctuate around USD 70-90 billion hereafter. Total flows would reach USD 2028 billion for 2013-2030 and USD 3499 billion for 2013-2050.
- Under scenario III (clean energy infrastructure funds + green bonds + climate change equity indices), USD 289 billion would be reallocated in 2013, USD 197 billion in 2020 followed by a gradual decrease to some USD 90 billion in 2040. Total flows under that scenario would reach USD 3684 billion for 2013-2030 and USD 5856 billion for 2013-2050.