

European Association of Public  
Sector Pension Institutions

Association européenne  
des institutions de retraite  
du secteur public

Europäischer Verband  
der Versorgungseinrichtungen  
des öffentlichen Dienstes

## On the Green Paper “Long-term Financing of the European Economy”

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## Introductory Remarks

EAPSPI, the European Association of Public Sector Pension Institutions, welcomes the European Commission's invitation to participate in the debate on long-term financing. EAPSPI compliments the European Commission for promoting the subject and including all market participants in the discussion. In terms of the organisation of the consultation, EAPSPI underlines the adequate time frame of the consultation phase chosen by the European Commission which gives interested stakeholders the opportunity to elaborate their contributions thoroughly.

The European Commission has chosen a holistic approach to the issue involving all stakeholders. EAPSPI appreciates that the European Commission acknowledges that pension funds and insurance undertakings are institutional investors and would like to underline they are key players in the financial markets and form an important part of the European economy as institutional investors.

The scope of the Green Paper seems very broad and, at times, even too broad as the addressed stakeholders range from private households to SMEs to institutional investors. EAPSPI would like to point out that it is prepared to engage in more detailed discussions, should the occasion arise. In addition, EAPSPI suggests focusing on long-term investing rather than long-term financing. In contrast to long-term financing, long-term investing can be defined as the intention and capacity to hold also illiquid assets over the long-term. The conclusions drawn at a later stage on how to deal with or promote also illiquid assets may differ from those on how to promote long-term financing. This is displayed in the current discussion on various regulation processes.

EAPSPI considers that the key aim of pension institutions is to provide pensions for current and future pensioners in an effective and cost-efficient way. In this respect, EAPSPI would like to point out the importance of assessing the combined costs of various pieces of European regulation on long-term investment. Solvency and prudential regulation, as well as other financial market regulation should, at the very least, not be counterproductive to long-term investment. Clearly, this means that there should not be any provisions discouraging long term investments in a direct way, such as imposing Solvency II-like rules on pension funds. However, the indirect effects of the various pieces of European regulation on long term investments can prohibit pension funds, as well as other investors, from making or increasing long term investments due to cost and liquidity constraints resulting from such legislation. Examples

EAPSPI welcomes the recognition of pension funds as institutional investors

EAPSPI suggest focusing on long-term investing rather than long-term financing

Regulation should not be counter-productive to long-term investment

are: Financial Transaction Tax, European Market Infrastructure Regulation including margin requirements for OTC derivatives, Markets in Financial Instruments Directive/Regulation, Alternative Investment Fund Manager Directive and others. Not only are pension funds (and other institutional investors), faced with substantial direct costs of regulatory reform, but also with the indirect effects/costs of reform which are passed on by banks and other financial intermediaries.

Lastly, EAPSPI would like to stress that the investment decision must remain in the hands of the institutional investors. One result of the present consultation should not be that institutional investors are obliged to invest in long-term investments (e.g. infrastructure). To promote a framework in which these investments are made attractive to investors is welcome. The investment itself, however, needs to remain a voluntary decision in accordance with the specific investment strategy of the investor and with the existing legal framework.

As EAPSPI represents public sector pension institutions it has chosen to provide the following answers only to those questions of the consultation relevant to this field.

Investment decisions  
need to remain in the  
hands of the investors

## Question 1)

### Do you agree with the analysis above regarding the supply and characteristics of long-term financing?

EAPSPI in general welcomes the broad scope of the Green Paper, ranging from the supply of capital (by governments, corporations, households and external financing) to the intermediation process (through financial intermediaries or financial markets) and the discussion of cross-cutting factors (i.e. aspects of taxation, accounting, governance and reporting) to the supply of capital to SMEs and infrastructure projects. Especially with regard to the discussion of the supply of capital, EAPSPI agrees with the European Commission that governments are facing severe constraints in delivering capital due to debt reduction / austerity policies, private households prefer short term accounts due to precautionary motives and that also companies are holding back investments because of uncertainties of market demand and the business cycle. This leads to low levels of investments in long-term productive capital, which is economically essential and favourable because of its stabilising function.

EAPSPI also would like to mention some dangers associated with the very broad scope of the discussion trying to integrate every aspect related to the question of supporting long term investments. The problem is that the consultation is not addressing the essential issues in adequate detail. EAPSPI fully agrees with the formulation of the European Commission that the growth potential of an economy strongly depends on the ability of the financial sector to channel savings into productive investments. As these productive investments are long term and often illiquid by nature and therefore more "risky" in terms of expected returns, someone is supposed to carry these risks. In EAPSPI's opinion, the essential point is that pension funds can best deliver this kind of risk absorption and therefore strongly suggests a specific focus on the potential of pension funds as institutional long-term investors. By the very nature of their business models and their liability structure, pension funds are able to take on the risks of illiquid assets. In contrast to banks they perform nearly no transformation activity and thus do not face "bank-run" problems and in contrast to financial markets it is more transparent who bears the risks of investment decisions. Pension funds, are therefore able to be key players in the financial markets and form an important part of the European economy as institutional investors.

EU faces difficulties in supply of long-term capital leading to low levels of long-term investments

The scope of the analysis needs to be more detailed

Refocus on the potential of pension funds as institutional long-term investors

EAPSPI would like to point out that both pension funds and insurers can be suitable long-term investors. Given the structure and risks of their liabilities, pension funds, however, are in some cases even better designed for long-term investments than insurers. In particular, the fact that as a rule pension funds grant benefits only in case of the occurrence of insured events (e.g. retirement, death, or disability) and thus do not face risks of premature and pro-cyclical capital withdrawals or redemptions makes them especially suited for long term investments. Institutions which manage pension funds for the public-sector operate in the same regulatory environment as pension funds in general. It can be said that public sector pension funds are perhaps even better suited to playing a role in the long-term financing of the European economy as certain risks are less crucial, in particular, given the nature of the sponsors, the risk of sponsor insolvency.

Public pension funds better suited for long-term financing due to the nature of their sponsors

## Question 2)

### Do you have a view on the most appropriate definition of long-term financing?

EAPSPI suggests focusing on long-term investing rather than long-term financing. In contrast to long-term financing, which is defined very broadly in the Green Paper as “*the process by which the financial system provides the funding to pay for investments that stretch over an extended time period*” (p. 5), EAPSPI suggests the following definition: long-term investing can be defined as the intention and capacity to hold especially illiquid assets over the long-term.

EAPSPI fully agrees with the conceptual work in this respect done by the OECD in its project on “institutional investors and long-term investment” characterizing long-term investment as follows<sup>1</sup>:

- *Patience 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.

These principles also explain the advantages of pension funds as key players in capital markets: as active investors that absorb risks due to their capital intermediation and pooling functions and as investors that can take on a counter-cyclical role in capital markets due to their long-term perspective.

Long-term investing: the intention and capacity to hold especially illiquid assets over the long-term

Pension funds are risk-absorbing and counter-cyclical investors

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<sup>1</sup> See quotations at: <http://www.oecd.org/insurance/private-pensions/institutionalinvestorsandlong-terminvestment.htm>

## Question 6)

### To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

Thanks to the long-term nature of the liabilities and business model, pension funds are able to take on the risks of illiquid assets. This is possible as long as the risk and return profile of the investment is in line with objectives of the institutional investor. The sector of institutional investors is growing and makes them a major player in the investment market.

To support long-term investment strategies by institutional investors it is essential that taxation rules, valuation rules and any risk-based capital requirements are designed appropriately, fulfilling prudential requirements. Market mechanisms can then begin to give institutional investors a greater role to help achieve financial stability, debt sustainability and a sustainable economic development.

EAPSPI considers that the key aim of pension institutions is to provide pensions for current and future pensioners in an effective and cost-efficient way. In this respect, EAPSPI would like to point out the importance of assessing the combined costs of various pieces of European regulation on long-term investment. Solvency and prudential regulation, as well as other financial market regulation should, at the very least, not be counterproductive to long term investment. Clearly, this means that there should not be any provisions discouraging long term investments in a direct way, such as imposing Solvency II-like rules on pension funds. However, the indirect effects of the various pieces of European regulation on long term investments can prohibit pension funds, as well as other investors, from making or increasing long term investments due to cost and liquidity constraints resulting from such legislation. Examples are: Financial Transaction Tax, European Market Infrastructure Regulation including margin requirements for OTC derivatives, Markets in Financial Instruments Directive/Regulation, Alternative Investment Fund Manager Directive and others. Not only are pension funds (and other institutional investors), faced with substantial direct costs of regulatory reform, but also with the indirect effects/costs of reform which are passed on to them by banks and other financial intermediaries.

Lastly, EAPSPI would like to stress that the investment decision must remain in the hands of the institutional investors. One result of the present consultation should not be that institutional investors are obliged to invest in long-term investments (e.g. infrastructure). To

Appropriate design of taxation and valuation rules and risk-based capital requirements help support long-term investment strategies.

Solvency, prudential and financial market regulation should not be counterproductive to long-term investment

Institutional investors should not be obliged to invest in long-term investments

promote a framework in which these investments are made attractive to investors is welcome. The investment itself, however, needs to remain a voluntary decision in accordance with the specific investment strategy of the investor and with the existing legal framework.



## Question 7)

### **How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?**

We currently observe EU-initiatives, such as Solvency II for insurance companies and the intended revision of the current IORP-Directive, which aim at improving the prudential frameworks for insurance companies (Solvency II) and pension funds (IORP Directive) by implementing more risk-based supervision. In this respect, EAPSPI welcomes the recent statement of Internal Market and Services Commissioner Barnier<sup>2</sup> that his proposal for an IORP-revision (which will be submitted this autumn) will not cover the issue of solvency rules for pension funds because of the need for more research and data.

In principle EAPSPI agrees with risk-based supervision, in which similar risks should be subject to similar rules.

EAPSPI also agrees with the statement in the Green Paper that prudential objectives and the desire to support long-term financing should be balanced in the design and implementation of the prudential rules for IORPs. In our view the Commission and EIOPA should in this respect in particular take into account the potential impact of the revision of the IORP Directive on both the capacities of pension funds to pay adequate retirement benefits and on their capacities for long-term investing. It is encouraging to note that the Commission indicates in the Green Paper that supervisory rules should not hamper long-term investing. However, we are not convinced that this will be the case for the upcoming proposals from the Commission, especially taking into consideration that it has been suggested<sup>3</sup> that the Solvency II Directive for insurance companies (which contains several elements which limit LTI) could be taken as the basis for the revision of the IORP Directive. In our view such hampering of long term investing could be avoided by means of an appropriate framework which should inter alia take into account the principal differences between pension funds and insurance companies. The following issues should be dealt with in a revised IORP-Directive:

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<sup>2</sup> Statement by Internal Market and Services Commissioner Michel Barnier, Global Conference on Sustainability and Reporting, Amsterdam, 23 May 2013.

<sup>3</sup> See for example European Commission (2011), Call for Advice from EIOPA for the review of Directive 2003/41/EC (IORP II), Brussels, 30 March 2011.

(i) the (risk-based) capital requirements on specific asset categories should not be too burdensome;

(ii) the recovery periods should be long enough; and

(iii) application of a (harmonised) risk-free interest rate in order to value pension liabilities should be avoided, because of the resulting volatility of both the value of these liabilities and thus the funding ratios of pension funds.

Within the context of the ongoing process of the IORP-revision, the Commission should take into consideration that, if the condition of an adequate treatment of these elements is not met, the potentially resulting de-risking of the asset mix of IORPs would have negative effects on both pension benefits and on the European economy as a whole.

## Question 8)

### What are the barriers to creating pooled investment vehicles?

#### Could platforms be developed at the EU level?

If institutional investors (such as pension funds) decide to pool their investments with other institutional investors they may benefit from economies of scale, which may allow for lower trading costs, diversification and professional management. In order to optimize the benefits for institutional investors from using a pooled vehicle in practice certain conditions need to be met, such as adequate knowledge and experience of the manager of the vehicle, good governance and as far as possible pooling funds of similar types of investors with similar risk profiles.

Currently, several barriers for pooled investment vehicles exist, both practical barriers and other barriers.

What could create a barrier is a lack of the relevant knowledge. This particularly goes for long-term financing in the form of debt. In this market, it is mostly banks who have the appropriate in-depth knowledge and it may be that banks will not be willing to set up and/or manage such new types of pooled investment vehicles. This is the exact reason why certain other market parties have recently initiated infrastructure debt funds/investment vehicles themselves. The infrastructure debt market requires very specific knowledge which is not widely available, especially outside of banks who have dominated this market for the last 20 years or so.

Furthermore, certain tax issues may constitute barriers to the creation of pooled investment vehicles, in particular, local withholding taxes, local Corporate Income Taxes (CIT) and differences between countries regarding withholding taxes. It would be very beneficial for institutional investors to be able to apply for relieve at source of the taxes withheld instead of having to reclaim in all European countries, and with similar forms, instead of each country having its own form.

Finally any newly created European platform or vehicle should in our opinion not have any unjustified competitive advantage over existing market vehicles or structures in respect to long-term finance and LTI.

Investment pooling holds many advantages if certain conditions are met

Pooled vehicles need in-depth knowledge of e.g. infrastructure markets

Facilitating EU-wide tax relief procedures and forms

## Question 16) - 19) Taxation

The European Union is made up of different member states with diverse fiscal systems. Some of the taxes are common (e.g. VAT) though with differences (different tax bases with diverse tax rates), while some other taxes belong to a specific single member state or area (e.g. F.T.T.). Variations stem from different political strategies, diverse historical backgrounds, cultural characteristics or economic structures. Though it is accepted that a common fiscal scenario could have positive effects on investing, financing and savings, the coordination of broadly diverse fiscal systems should take into account the different national characteristics, especially when considering that fiscal policy remains a competence of the member states.

Different tax systems in different member states

Taxes are one of the factors in the investment equation, as investors consider net cash-flows. Incentives are another factor as they vary the investor's inflows/outflows, and prior to using them their aim should be clearly defined in terms of desired outcomes; otherwise their use would not be recommended.

At the time of evaluating the adequate taxation system, Corporate Income Taxation (CIT) should be considered, as well as the Personal Income Taxation (PIT). Debt and equity are usually taxed differently, and reforms should be implemented bearing in mind that CIT and PIT should pursue economic as well as social objectives.

CIT and PIT should pursue economic as well as social objectives.

Consumption (e.g. VAT) and personal (e.g. PIT) taxation can be used as a redistributive policy at the same time it is a revenue source. Meanwhile CIT is a major revenue inflow governments have and its policy should be used to balance possible market inefficiencies: some economic activities could be unattractive for the individual investor though desirable in social terms, and in this scenario the public intervention in terms of incentives would be desirable.

In general, bearing in mind the long-term financing of the European Union, stability in fiscal matters can make a contribution to encouraging European citizens to save and finance long-term investing. But it should not be forgotten that financially speaking the alternatives for European financing are not the European markets exclusively, opting between countries and time frames, but the rest of the world economies as well: If Europe does not match the rest of the world competitors in this area (return on investment, market stability and interest/currency rates), its economic future will cast grey clouds over European residents. Economic activity is to be subject to taxes that will finance public services, and will receive tax incentives that should correct undesirable effects, but at the same time

Stability in fiscal matters can encourage saving and financing long-term investing

should not be excessively burdened by government' intervention, as long as there are alternative competitor economies - in the present economic model globalisation is a fact.

In general terms, in order to incentivise pension savings, certain common features of basic and occupational pensions could be recommended, in particular taxation of benefits paid rather than contributions to pension institutions.

Taxation should reflect common features of basic and occupational pensions

## Question 20)

**To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour?**

It is difficult to provide a specific response to this question from a European point of view since the interplay between different solvency and accounting rules is complex. Clearly, for pension funds, accounting and solvency rules are both part of the same question. Adding to this complexity is the existence of certain “cultural” biases in terms of asset allocation in different countries.

However, as outlined above, the issue is of great importance and EAPSPI would like to cite here extracts of a recent OECD report<sup>4</sup> on the subject published in November 2012 by Juan Yermo and Clara Severinson. Juan Yermo is Head of the Private Pensions Unit of the Financial Affairs Division within the OECD’s Directorate for Financial and Enterprise Affairs.

*Recent developments in accounting, in particular the introduction of fair value principles, have brought greater transparency and consistency to financial statements. [...] However, the move towards fair value has also brought a greater focus on short-term market fluctuations, and some would argue that this has been to the detriment of the long-term investment horizon. It is particularly surprising to find that the strictest fair value methodology is applied to pensions, even though these have, in general, longer duration liabilities than banks and insurers, which currently benefit from other valuation techniques such as historic or book values for some of their assets.*

[...]

*Fair valuation principles used for accounting purposes have been a key factor behind the decline in equity allocations in pension fund portfolios in the United Kingdom.*

[...]

*Care must be taken in the design and implementation of mark-to-market valuation principles and risk-based funding rules as they could incentivise pro-cyclical investment behaviour such as the fire-sale of assets in market downturns.*

Accounting and solvency rules are both part of the same question

OECD:

Fair value principles result in short-term focus

Pension funds have longer duration liabilities than banks and insurers  
Pension funds have

<sup>4</sup> Severinson, C. and J. Yermo (2012), “The Effect of Solvency Regulations and Accounting Standards on Long-Term Investing: Implications for Insurers and Pension Funds”, OECD Working Papers on Finance, Insurance and Private Pensions, No. 30, OECD Publishing.

The report concludes:

*Major regulatory and accounting changes are underway that could have a profound impact on the long-term investment decisions of life insurers and pension plans. Life insurers and pension plans may respond to these developments by moving further away from products and promises with return guarantees in favour of those that pay out benefits to policyholders and beneficiaries in line with market returns, thus further shifting the risk onto individuals. [...]*

*The move towards fair value accounting principles will have major impacts on life insurers and pension plans as they will need to consider to what extent they wish to minimise accounting volatility, for example by transferring risk from sponsors to members and policyholders or by matching the characteristics of their assets with their liabilities, and what level of volatility is acceptable given the search for excess investment returns.*

In view of the complexity of the issue, further study is needed for final evaluation. The valuable work of the OECD in this area provides essential input to the debate.

Further study is needed for final evaluation

### What alternatives or other ways to compensate for such effects could be suggested?

Certain held-to-maturity bonds should be treated in a specific way. From a pension institution's perspective, bonds held to maturity as an optional asset or investment class would most likely help to stabilize the long-term financing of the European economy. In view of the long term low interest level prognoses in the EU and other industrialized countries, and pension schemes with a current guaranteed return normally higher than the key policy rates throughout Europe, there is a clearly substantial value and sensitivity risk in buying government bonds – and also credit bonds – if the interest level should go up after acquisition. The result could be considerable write-downs. The basic accounting approach for such securities should be at amortized cost until fixed maturity date, and only the amortized interest return will at year end be taken into the books as operating income.

For example, German accounting standards entail a different handling of bonds when held for trading purposes (here some aspects of fair value accounting / mark-to-market valuation are applied) compared to bonds held to maturity. For the latter, amortized cost accounting is applied, see § 253 and § 341b of the German Commercial Code.

In the future Solvency II capital requirement regime bonds, held to maturity, should be included as an optional asset class booked at amortized cost.

'Held-to-maturity' portfolios must be well diversified and comprise securities issued by highly creditworthy institutions. As an example one of EAPSPI's member institutions is practicing minimum AA-rating for bonds with a duration of over 10 years; A- rating for bonds between 1 and 10 years; non-rated bonds are subject to pre-evaluation and credit lines under the supervision of a credit committee.

In this way, accounting principles can facilitate long-term investment in high quality credit and reduce volatility in the balance sheet. One European public-sector pension fund estimates that one third of its balance sheet is comprised of such "held to maturity" instruments.

Nature of held-to-maturity bonds should be reflected in accounting approach



## Question 25)

### Is there a need to develop specific long-term benchmarks?

There is indeed a need to develop a specific LTI-benchmark. Generally speaking the availability of benchmarks leads to more transactions, and the resulting higher liquidity in the markets concerned will result in more attractive investment opportunities.

In this respect it should be borne in mind that an overall LTI-benchmark as such may not be the optimal solution, if at all possible from a practical point of view. Benchmarks for separate illiquid types of asset categories (and maybe even subclasses within specific asset categories) focusing on the different risk-return profiles of these categories would seem preferable.

Data will be key in this respect. Industry-bodies can (and in our view: should) play an important role in this respect. Also, the development of similar industry-bodies for other, not yet 'covered' illiquid asset categories / business sectors could be promoted by the EU and national governments.

From the point of view of socially responsible investments (SRI), existing benchmarks are insufficient. In particular, market capitalisation-weighted indices appear to provoke instability in the management of equity portfolios.

It may furthermore be considered as relevant that several European public pension funds have recently tried to elaborate well diversified equity indices focusing on correlations, because they believe that the promotion of alternatives to market capitalisation-weighted indices can contribute to fostering financial market stability. As an example, one of these pension funds has created its own SRI framework – which covers the whole spectrum of ESG issues – and has implemented it within its asset portfolio. This pension fund decided to collaborate with a research centre and an index provider to create its own SRI small/mid cap index which will be used as a benchmark for passive management.

These isolated R&D efforts show the need at the level of the whole long term asset management industry to open new doors in terms of small/mid cap equity management and to have access to a more diversified SRI offer in this field. Through the creation of these specific indices, asset managers will benefit from new tools, making it easier for investors to make their first steps in SRI.

Benchmarks lead to more transactions and attractive investment opportunities

Practical barriers against an lti benchmark

Approach of European public pension funds to elaborate well diversified equity indices resulting in e.g. SRI framework

## About EAPSPI

The European Association of Public Sector Pension Institutions (EAPSPI) covers 26 pension institutions and associations of the public sector out of 16 European countries and speaks for 33 million people throughout Europe. EAPSPI's members and observers cover the special basic pension schemes for civil servants or the supplementary occupational pension schemes for public employees.

EAPSPI offers a network for the pension institutions of the public sector and a common platform towards the European and other international institutions. However, EAPSPI is not a pressure group. EAPSPI merely aims to position itself as a pension expert in order to demonstrate the effects especially of new legislative projects.