G20/OECD HIGH-LEVEL PRINCIPLES OF LONG-TERM INVESTMENT FINANCING BY INSTITUTIONAL INVESTORS

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This document contains the eighth version of the G20/OECD High-Level Principles on Long-Term Investment Financing by Institutional Investors developed by the OECD Task Force on Institutional Investors and Long-Term Financing. The Task Force is open to OECD, G20, FSB, APEC members and includes several international organizations.

This version includes comments expressed on previous versions at the occasions of 4 plenary meetings of the Task Force and numerous written contributions, including inter alia from the (OECD, G20, FSB and APEC) Members of the Task Force, several OECD bodies [such as the Committee on Financial Markets (CMF) and the Insurance and Private Pensions Committee (IPPC)], International Organizations (IMF, World Bank, FSB, various SSBs), G20 Study Group on Finance for Investment and the European Commission. It has also been submitted for public consultation, which provided a a large number of very constructive comments from various stakeholders (including industry and trade unions). This version takes also into account the comments expressed at the July 2013 meeting of the G20 Finance Ministers and Central Banks Governors who welcomed the Principles and called on the OECD to identify approaches to their implementation. The present version is submitted to the G20 Leaders for endorsement.

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The OECD has developed substantial work on long-term investment (including through its recent project on institutional investors and long-term investment).[1] This work has allowed delivering of numerous reports [in particular under the aegis of the Working Party on Private Pensions (WPPP)] and policy notes (for instance the 2012 G20/OECD Policy note on pension funds financing for green infrastructure and initiatives). This work has been widely disseminated and also increasingly recognised outside the OECD, while the need to develop related guiding principles based on such work has been further encouraged and planned by the Insurance and Private Pensions Committee and its WPPP. On the occasion of their 15-16 February 2013 meeting in Moscow, G20 Finance Ministers and Central Bank Governors stated that they were looking forward to an OECD report on High-Level Principles on Long-Term Investment Financing by Institutional Investors by the G20 Leaders Summit in September 2013.[2] This is also fully consistent with the conclusion of the G20 diagnostic note on issues related to long-term investment financing which recognised the important potential role of institutional investors.

The high-level principles are designed to assist OECD, G20 and any other interested countries to facilitate and promote long-term investment by institutional investors, particularly among those institutions, such as pension funds, insurers and sovereign wealth funds that typically have long duration liabilities and consequently can consider investments over a long period provided these are prudent and capable of producing a reasonable risk-adjusted return. The principles complement and do not substitute any existing international principles and/or guidelines. They foster consistency in approaches for long-term investment across different policies and jurisdictions. Certain issues covered by the principles are based on existing recommendations of the OECD in this area and are consistent with them, such as the OECD Principles of Corporate Governance, the OECD Core Principles for Occupational Pension Regulation, the OECD Guidelines for Insurers' Governance, the OECD Principles for Public Governance of Public-Private Partnerships, the OECD Green Growth Declaration, the OECD Agreement on Officially Supported Export Credits, the OECD Guidelines for Multinational Enterprises and the OECD Code of Liberalisation of Capital Movements, which encourages international investment by institutional investors. The proposed high-level principles also complement international standards in other areas, such as IOSCO's Principles of Securities Regulation, the IAIS Core Principles on Insurance, the IOPS' Principles for Private Pension Supervision, the Santiago Principles for Sovereign Wealth Funds, as well as broader recommendations applicable to all investors such as the Principles for Responsible Investment (PRI).

[1] See www.oecd.org/finance/lti.

[2] The recent Group of Thirty report on long-term financing also encouraged further guidance by the OECD in this field.

FRAMEWORK

Institutional investors such as pension funds, insurers, sovereign wealth funds, investment companies and endowments held in total well over USD $85 trillion in assets across the world in 2011. Their growth and development have brought a transformational change in financial systems. While they are most present in developed markets, emerging market institutional investors are expected to continue to increase in both scale and influence over the next decades. Traditionally, this heterogeneous group of investors – and, in particular, pension funds, life insurers, and sovereign wealth funds – has been seen as sources of long-term capital with investment portfolios built around the two main asset classes (bonds and equities) and an investment horizon tied to the often long-term nature of their liabilities.

The exemplary case are pension funds, which start collecting contributions when individuals enter the workforce and may only start paying benefits with the assets accumulated thirty to forty years later. Furthermore, increasing longevity has increased the period over which payments need to be made, further extending the duration of pension fund liabilities. Life insurers also tend to have long-term liabilities, especially as major providers of annuities and similar retirement products. Sovereign wealth funds and state-owned investment funds are a third key group of investors that can have long investment horizons. In addition, in some countries, public-sector entities, such as national development and export credit institutions are also important sources of long-term finance.

The growth of institutional investors can bring about the prospect of a larger and more diversified source of long-term financing for physical and intangible investment needs across all sectors in the economy and specifically in key drivers of growth, competitiveness and employment such as infrastructure, company equipment, education and skills, research & development, and new technology. Long-term financing is also essential for the development of small and medium-sized enterprises, especially young, innovative, high-growth firms. Many countries face gaps in the financing of long-term investment in these sectors. There is also a need to address the challenge of climate change and other pressures on the environment via long-term investments in renewable energy and low-carbon technologies. The growth of institutional investors and higher allocations to assets that directly contribute to the financing of long-term investment are therefore welcome developments as long as their associated risks are properly understood and managed.

A long-term investment horizon can also bring direct benefits to institutional investors, as they can take advantage of long-term risk premia, including an illiquidity premium rewarding them for exposure to less liquid, long-term assets (such as infrastructure). Taking a long-term view also allows investors to appraise and benefit from the fundamental value of their investments. Holding investments over the longer term can also reduce turnover within portfolios and thereby costs – this being an important consideration for pension funds since for instance a 1% charge on assets over 40 years can reduce eventual pension income by around 20%. The risks associated with long-term investments should also be carefully assessed, including market and illiquidity risks (and related portfolio constraints), climate and other environmental risks, and exposure to potential future climate regulation. The governance requirements of long-term investments may also be more complex than those of traditional investments.

As institutional investors generally benefit from stable net income flows, they can also follow a less cyclical investment pattern, which is another feature of long-term investing. They can therefore act to some extent as shock absorbers at times of financial distress, and may contribute to financial stability. The growth of these institutions has also contributed to the development of capital markets, providing financing to companies and governments and helping to develop mechanisms for corporate control and risk management. At the same time, individual investors have been able to pool their savings in products where investment risks can be diversified and insurance products that protect them from a variety of life related and property risks.

The OECD therefore associates long-term investment by institutional investors with 'patient', 'productive' and 'engaged' profitable capital.[3] Despite its potential benefits, there are cyclical and structural impediments to such investment. For instance, the current environment of low interest rates and uncertainty over future growth prospects and over policy developments can hinder the willingness of institutional investors to invest in long-term assets. Population ageing may have also reduced the risk appetite and time horizon of investors.

In addition, governments and other competent authorities such as the regulators and supervisors of institutional investors play a key role in facilitating long-term investment. The government can create appropriate and consistent policies and framework conditions for long-term investment and is also an important source of long-term investment.

The proposed high-level principles identify a set of general recommendations to promote long-term investment by institutional investors and improve the functioning of markets while fulfilling prudential requirements and avoiding potential detrimental impacts on other investments.

SCOPE AND COVERAGE

These Principles aim to help policy makers design a policy and regulatory framework which encourages ***institutional investors*** to act in line with their investment horizon and risk-return objectives, enhancing their capacity to provide a stable source of capital for the economy and facilitating the flow of capital into ***long-term investments***. The principles address regulatory and institutional impediments to long-term investment by institutional investors and aim to avoid interventions that may distort the proper functioning of markets. The principles are intended to be consistent with existing regulatory standards for institutional investors, such as those addressing the financial regulation of investment and solvency.

The principles provide general orientation and guidance, are not meant to be exhaustive and focus on selected major issues. They are non-binding and may be applicable to all or only some categories of institutional investors, taking into account their respective specificities. Their implementation would also require careful consideration of the different business models and particularities of the different kinds of institutional investors.

The Principles have been developed by the OECD Task Force on Institutional Investors and Long-Term Financing. This Task Force, working under the aegis of the OECD Committee on Financial Markets and Insurance and Private Pensions Committee, is open to G20, FSB and APEC members. The process has included numerous consultations with relevant stakeholders, including a written public consultation during the month of May and the organisation of a G20 Russian Presidency / OECD High-Level Roundtable on Institutional Investors and Long-Term Investment on 28 May 2013.

[3] See Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies, http://www.oecd.org/daf/fin/private-pensions/48616812.pdf.

PRINCIPLES

Principle 1: Preconditions for long-term investments

1.1 Governments[4] should put in place framework conditions that are favourable to long-term investment financing. When evaluating policies to promote long-term investment by institutional investors, policymakers should ensure its consistency with the best interest of members, investors, beneficiaries, policyholders and other relevant stakeholders, and consider its wider potential public impact. In particular, long-term investment can help achieve broader policy goals such as financial stability, debt sustainability, job creation, inclusive growth, higher living standards, competitiveness, sustainable economic development and green growth.

1.2 Policies to promote long-term investment by institutional investors should be consistent with financial regulation objectives, ensuring the security, quality, liquidity, profitability and appropriate diversification of the portfolio as a whole.

1.3 Governments should support stable macroeconomic conditions that are conducive to longer-term investment, by maintaining credible monetary policy frameworks, responsible fiscal policies and sound financial sector regulatory environments.

1.4 Governments should ensure that capital markets and financial intermediaries are subject to an appropriate and predictable regulatory and supervisory framework within and across jurisdictions. Tax neutrality towards different forms and structures of financing should be promoted. Investment frameworks should as far as possible be made consistent across countries to facilitate the cross-border flow of long-term financing.

1.5 A favourable business and investment climate and the consistent and effective enforcement of the rule of law are essential for long-term investment. Governments should create predictable, stable, transparent, fair and reliable business regulation and supervision and administrative and procurement procedures. In particular, policies should consider the long-term financing needs of new firms and small and medium-sized companies. They should also promote an effective framework for fair competition and sound corporate governance, and clear and reliable creditor rights and insolvency regimes.

1.6 Governments should ensure that the legal and institutional preconditions are favourable for the development of institutional investors with a longer term investment horizon. Such investors should be adequately regulated and supervised, taking into account their specificities and the risks they face, and in line with relevant international standards.

1.7 Governments should develop and publish their long-term investment plans, consistent with a sound fiscal framework, after carrying out a suitable impact assessment and cost-benefit analysis of projects. These investment plans and their associated regulatory, judicial, and tax environment should be transparent, consistent and contribute to sustainable development and growth.

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[4] Government is defined broadly, including all competent authorities at international, national and sub-national level.

1.8 Where appropriate, governments should provide opportunities for private sector participation in long-term investment projects such as infrastructure and other relevant projects via, for instance, public procurement and public-private partnerships. Investment opportunities should enable the different parties to earn returns commensurate to the risks they take. Proper planning and effective management of such initiatives is recommended in order to ensure a regular, coherent pipeline of suitable projects. These initiatives should be supported by a transparent, sound and predictable regulatory framework and subject to effective monitoring and accountability. They also require capacity building in government at both the national and local level.

1.9 Government should consider issuing appropriate long-term instruments in line with their debt management and capital market development objectives. Such instruments underpin the development of long-dated private sector securities markets and can support asset-liability management by institutional investors and complement long-term investment portfolios.

Principle 2: Development of institutional investors and long-term savings

2.1 Governments should promote policies that encourage and support the development of long term savings and of institutional investors and their role in long-term investment financing and financial market stability in a sound and sustainable manner, complementing and building on the expertise and activities of other financial intermediaries, such as banks.

2.2 Governments should promote the development of long-term savings through savings mobilisation policies. Such policies may consider the use of default mechanisms such as automatic enrolment as well as, where appropriate, mandatory arrangements. When relevant and subject to the macroeconomic situation, appropriate financial incentives to long-term saving should be provided and tax impediments removed. Governments should also promote the development of long-term savings through pooled investment vehicles and collectively organised long-term savings and retirement plans, increased awareness amongst the population, financial inclusion policies, and the promotion of financial literacy.

2.3 Governments should promote measures to enhance the efficiency and reduce the costs of long-term saving schemes and institutional investors. Such measures, as related to long-term institutional investors, could include enhancing transparency on fees, fostering competition among financial institutions, exploiting economies of scale, and reducing incentives for excessive portfolio turnover.

Principle 3: Governance of institutional investors, remuneration and asset management delegation

3.1 The governing body of an institutional investor should ensure that the investment strategy of the institution takes into account the profile and duration of its liabilities and follows a prudent approach.

3.2 The governing body of an institutional investor should collectively have adequate skills to design, assess, monitor, and review its investment strategy, including the allocation to long-term assets. Where necessary, it should seek appropriate independent advice and training.

3.3. The governing body of an institutional investor should ensure that the investment management personnel and any external asset managers have the necessary capability to implement the investment strategy and manage those investments in line with the institution's objectives. If outsourcing to external asset managers, the governing body has the duty to ensure that the investment decisions are in line with its objectives.

3.4 The governing body of an institutional investor should ensure that the institution can properly identify, measure, monitor, and manage the risks associated with long-term assets as well as any long-term risks – including environmental, social and governance risks - that may affect their portfolios.

3.5 The governing body of an institutional investor should ensure that conflicts of interest that may affect their decisions and those of the persons or entities involved in the management of investments, including any long-term assets, are identified and adequately addressed.

3.6 The governing body of an institutional investor should observe its fiduciary duties towards the ultimate owners or beneficiaries of the assets they oversee. Such duties, when applicable, should include the prudent and efficient management of any long-term assets and the informed and effective use of their investor rights, including shareholder and creditor rights. Those persons and entities involved in the management of the assets of institutional investors should act in consistency with those fiduciary duties or their associated contractual obligations.

3.7 The governing body of an institutional investor should regularly monitor the performance of both external and internal fund managers. Performance should be evaluated over a period of years, taking into account the institution's investment horizon, its asset-liability management objectives and the level of risk implied. Performance-based elements and contract clauses of fund managers' and senior executives' remuneration should be based on long-term, risk-return criteria.

3.8 Regulatory and supervisory authorities overseeing institutional investors and other actors within the investment management chain should monitor the governance, agency relationships, remuneration, and risk management mechanisms underpinning long-term investment and take prompt and adequate measures when relevant. They should, where appropriate, provide guidance to institutional investors regarding the governance and risk management requirements to meet long-term investment objectives.

Principle 4: Financial regulation, valuation and tax treatment

4.1 The financial regulatory framework - including valuation rules, any risk-based capital requirements and other prudential measures - for institutional investors should reflect the particular risk characteristics of long-term assets appropriately. The framework should also consider the investment horizon and typical holding period of these investors, while promoting their soundness and solvency as well as broader financial stability and consumer protection. Excessive or mechanistic reliance on external investment or creditworthiness analysis (such as credit rating agency ratings) should be avoided.

4.2 Solvency, accounting and funding requirements for institutional investors should avoid creating incentives for procyclical investment strategies. Any risk-based solvency rules should reflect the suitability of long-term assets for asset-liability management purposes, taking into account the level of predictability of cash flows.

4.3 The transparency, consistency, relevance and reliability of valuation methods for long-term assets should be promoted, as well as the development of appropriate benchmarks for such assets.

4.4 The tax environment and policies should remain stable and avoid creating impediments to long-term investment by institutional investors, including cross-border investment. They should also be subject to regular monitoring to prevent abuse, in particular in terms of international competition and regulatory arbitrage.

4.5 Governments should collaborate to promote greater consistency and strengthen the regulatory and supervisory frameworks for institutional investors, which may facilitate open, free and orderly capital flows and long-term cross-border investment by institutional investors.

4.6 Monitoring the impact of the regulatory and supervisory framework should include consideration for the effect of this framework on long-term investment.

Principle 5: Financing vehicles and support for long-term investment and collaboration among institutional investors

5.1 Public intervention in long-term investment projects - selected in light of socio-economic and environmental impact assessments - should be decided on the basis of identified market failures, should avoid crowding-out private investments, and should be selected by carrying out appropriate cost-benefit analysis of such interventions and ensuring that any public support is appropriately priced and is subject to fiscal considerations.

5.2 Governments may consider providing risk mitigation to long-term investments projects where it would result in more appropriate allocation of risks and their associated returns. Such risk mitigation mechanisms may include credit and revenue guarantees, first-loss provisions, public subsidies, and the provision of bridge financing via direct loans.

5.3 Governments should establish the necessary regulatory framework for pooled investment vehicles and securities channelling financing for long-term investment in a sound and sustainable manner.

5.4 In markets with limited participation by institutional investors, governments, national development banks, and multilateral development agencies should consider the need for establishing and promoting pooled vehicles for long-term investment, and supporting other instruments for long-term investment such as project bonds or securitised assets, and risk mitigation policies. Such financing vehicles should have an investment horizon in line with those of the underlying projects and should be developed in close cooperation with institutional investors.

5.5 Governments should establish a policy environment to address any market failures which inhibit long-term investment by institutional investors in start-up firms with a high growth potential, and more generally in small and medium-sized companies. They should consider mechanisms to facilitate the provision of seed capital to such firms and their access to appropriate financing, utilising competitive processes and private sector expertise. They should also consider establishing suitable financing vehicles for such firms, where appropriate,.

5.6 Collaborative actions and resource sharing amongst institutional investors and with other financial institutions should be encouraged and supported in order to facilitate the exchange of expertise, ensure the effective exercise of ownership rights and to allow sufficient scale and diversification to be reached for investment in large, long-term projects.

Principle 6: Investment restrictions

6.1 Where applied, restrictions on long-term investment by institutional investors should be consistent with diversification and financial regulation objectives. They should be reviewed regularly and, where appropriate, they should be eased subject to necessary safeguards being in place, such as strong governance and risk management mechanisms, effective supervision, and appropriate diversification.

6.2 Governments should avoid introducing or maintaining unnecessarily barriers to international investment – inward and outward - by institutional investors, especially when targeted to long-term investment. They should cooperate to remove, whenever possible, any related international impediments.

Principle 7: Information sharing and disclosure

7.1 Information sharing on long-term investments should be promoted at both the national and international level subject to cost and efficiency considerations. Data collection and information sharing can facilitate monitoring by supervisors, enhance the knowledge of institutional investors, reduce information asymmetries and improve the functioning and liquidity of markets.

7.2 Governments and international organisations should evaluate the need for promoting further research and the establishment of an international information platform accessible to investors that would provide comparative information on existing or foreseen long-term investment projects and their financing needs.

7.3 Where appropriate, institutional investors should disclose with sufficient granularity information on the extent to which their investment strategies are in line with their investment horizon and how they address long-term risks.

7.4 Institutional investors should be encouraged to report their recent allocation to and performance of different long term assets following standardised classifications and methods, while ensuring the confidentiality of any market-sensitive or proprietary information. The reporting should have an appropriate frequency and should include performance measures calculated over sufficiently long periods. Such information should be at least available for members, policyholders and other beneficiaries as well as supervisory authorities. To fulfil those reporting requirements, adequate existing reporting sources should be used as far as possible.

Principle 8: Financial education, awareness and consumer protection

8.1 An appropriate financial inclusion and consumer protection framework combined with financial regulation should promote long-term investment by institutional investors serving the retail market and to protect stakeholders, policyholders and beneficiaries of institutional investors in relation to such long term investment.

8.2 Tailored financial education and awareness strategies should be put in place to inform potential and actual users of institutional investment vehicles about the benefits of long-term saving and investing, as well as any potential risks and costs.

8.3 Default investment mechanisms for those members who do not exercise choice could be put in place in retirement savings systems. Those mechanisms should be consistent with the members' objectives, risk preferences and time horizons.