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Economic Briefing

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Foreword

"Lehman Brothers Collapse – Five Years After"

On 15 September 2008 the merchant bank Lehman Brothers filed for bankruptcy, triggering a series of events that led to the worst financial crisis and global recession since the Second World War. The G20 was thrust into prominence as the central economic policy coordination forum in the near financial meltdown of 2008. In its first year of meeting, at the Leaders' Summit, the G20 showed the necessary political will to avert a second Great Depression. The ILO estimated that this coordinated action of 2008 and 2009 saved nearly 30 million jobs. An ambitious Financial Action Plan was adopted at the London Summit in April 2009. The then G20 Chair, Gordon Brown, said "never again will the financial sector be in control of the real economy". After strong pressure from the international labour movement in September 2009 in Pittsburgh, the G20 committed to "putting quality jobs at the heart of the recovery".

However, in 2010, the G20 governments panicked in the face of resurgent financial markets and prematurely shifted from supporting global growth, jobs and economic rebalancing to cutting public expenditure and excessive austerity. The result, five years later, is that the "recovery" has not materialized. OECD and IMF forecasts for global growth have been revised downward six successive times. Unemployment remains some 50% higher in the industrialised countries than before the crisis, and 100 million more people in the developing countries live in extreme poverty.

In several countries even on the basis of the most optimistic assumptions, it will take five more years for income per head to return to pre-crisis levels. Cohorts of young people are being scarred by the experience of joblessness.

The underlying causes of the crisis remain unaddressed. The financial lobby has effectively watered down the policy measures necessary to re-regulate the financial sector. The Financial Stability Board and its members have collectively failed to meet deadlines. Ownership of the banking sector is now more concentrated than it was before 2008, despite the commitments made to ensuring there could no longer be banks that were "too big to fail".

Two decades of rising inequality in most G20 countries has not been reversed. Instead austerity policies have provoked an acceleration of income inequality.

Eight G20 Summits have now passed since 2008 and the language of the Leaders' Declaration in the most recent St Petersburg Summit has undoubtedly shifted in the direction of the global labour movement's concerns[1]. The need for inclusive growth, quality jobs and even collective bargaining are all recognised. But the gap

John Evans, ITUC Chief Economist.

between the language of the Declaration and the implementation of policies on the ground remains vast.

We are engaged in assessing some of the specific initiatives that have been commissioned by the G20. In this second ITUC-TUAC Economic Briefing, Pierre Habbard, ITUC-TUAC Senior Policy Adviser, assesses two initiatives of the G20 agenda on tax avoidance and on long-term investment. In St Petersburg the G20 endorsed two potentially significant texts prepared by the OECD: an Action Plan on Base Erosion and Profit Shifting (BEPS) to curb aggressive tax planning schemes by multinational enterprises (MNEs)[2]; and new High-Level Principles of Long-Term Investment Financing by Institutional Investors[3].

The ITUC, TUAC and our Global Unions partners will be tracking the implementation of the commitments in these Declarations over the months ahead and calling for the necessary policy shift to bring about a real, sustainable, job-rich and inclusive recovery.

John Evans

1 See ITUC-TUAC Evaluation of the Outcome of the St Petersburg Summit
2 http://www.oecd.org/newsroom/closing-tax-gaps-oecd-launches-action-plan-on-base-erosion-and-profit-shifting.htm
3 http://en.g20russia.ru/load/782768688

Economic Briefing

A review of the G20 agenda on tax avoidance and on long-term investment

The OECD Action Plan on Base Erosion and Profit Shifting

For years the OECD has been concerned about the risk of double taxation of the corporate income of MNEs between jurisdictions. The tone changed dramatically following the 2008 financial crisis. Five years into the crisis the OECD Secretariat staff states that "national tax laws have not kept pace with the globalization of corporations and the digital economy, leaving gaps that can be exploited by multinational corporations to artificially reduce their taxes. [We] clearly have reached the point where the governments don't care anymore about taboos, and they just say we cannot be bound by pure contractual arrangements. It's not possible to only allocate the profit through only contractual arrangements"[4].

The Base Erosion and Profit Shifting (BEPS) Action Plan is a roadmap comprising 15 measures to curb MNEs' aggressive tax planning aiming at (i) reducing the taxable income base ("base erosion") or (ii) moving profits away from economically relevant but high tax-jurisdictions to economically irrelevant but low-tax jurisdictions ("profit shifting"). The Action Plan emphasises the specific challenges of the digital economy and the treatment of "hard to value" intangibles (patents, brands, research and developments).

The deliverables of the Action Plan are expected in two-three years and would result in new OECD recommendations on tax rules, amending existing OECD texts (the OECD Model Tax Convention on Income and on Capital[5] and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[6]) and the development of further analytical research and data collection.

4 http://uk.reuters.com/article/2013/07/19/g20-tax-corporate-idUKL6N0FO2ZQ20130719
5 http://www.oecd.org/tax/treaties/47213736.pdf
6 http://www.oecd.org/tax/transfer-pricing/transferpricingguidelinesformultinationalenterprisesandtaxadministrations.htm

Illustrative examples

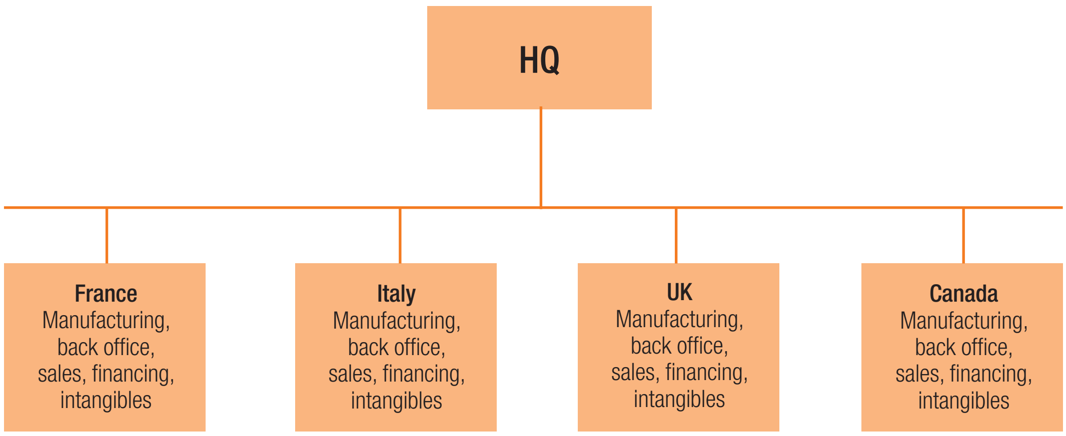
To help understand the issues addressed by the OECD Action Plan, a simplified structure of an MNE is used to illustrate different types of aggressive tax planning:

- Manipulating intra group transfer pricing;
- Excessive deduction of debt interest and other payments;
- Hard to value and shifting of intangibles;
- Avoiding permanent establishment status; and
- Opacity of MNE tax schemes and the need to shift to country-by-country reporting to tax authorities.

Changing structure of the MNE

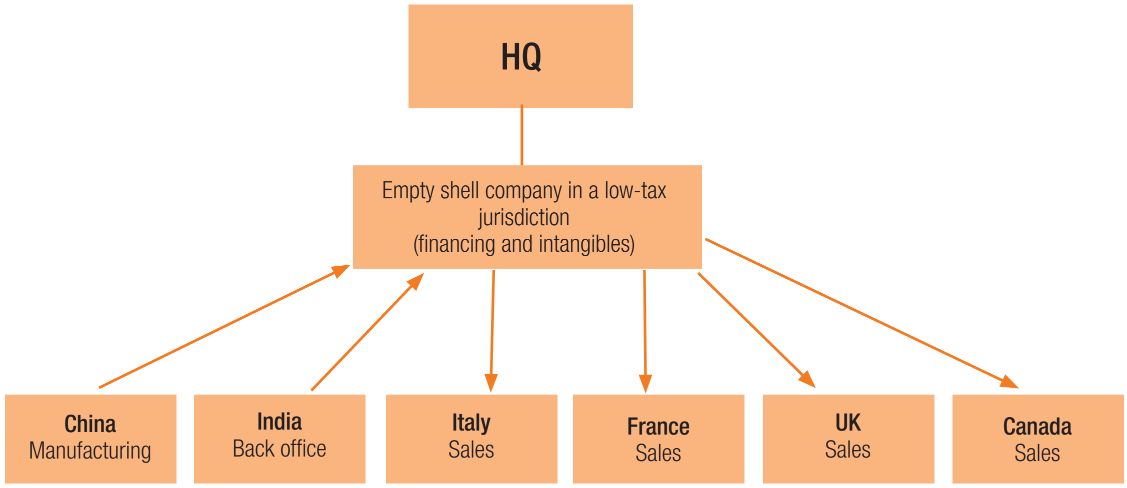
At the outset it is important to address the changing structure of the MNE in the past two decades. Figure 1 shows the traditional structure of an MNE, the one prevailing in the 1960-1980s, consisted of (i) a headquarters and (ii) stand-alone subsidiaries, each having relative operational autonomy (regarding manufacturing and production, service, back office, financial and intangibles, sales & marketing). In this model, each subsidiary generates profits in line with the economic substance of its activities.

FIGURE 1: TRADITIONAL STRUCTURE OF A MULTINATIONAL ENTERPRISE



That model, however, is no longer relevant to understand how today's MNEs operate. With the emergence of global value chains, production, back office services and sales are on the whole separated from sales and marketing to take advantage of regional and country-specific competitive advantage. Figure 2 provides a simplified representation of a structure of a MNE today. Manufacturing is entirely located in China, back office entirely located in India, while the French, Italian, British and Canadian subsidiaries retain sales functions only. Central to the MNE structure, an "empty shell" company is located in a low-tax jurisdiction (for example, a non-OECD tax haven but also some OECD jurisdictions such as Ireland, Luxembourg, the Netherlands) through which all intra-group transactions transit. The empty shell company also owns key intangibles assets of the MNE (patents, licenses, royalties). It is an empty shell company because its contractual value (ownership of patent rights, royalties, financing of the MNE) is disproportionately high compared to its economic substance (an office, a desk and a telephone line).

FIGURE 2: MNE STRUCTURE BASED ON GLOBAL VALUE CHAINS



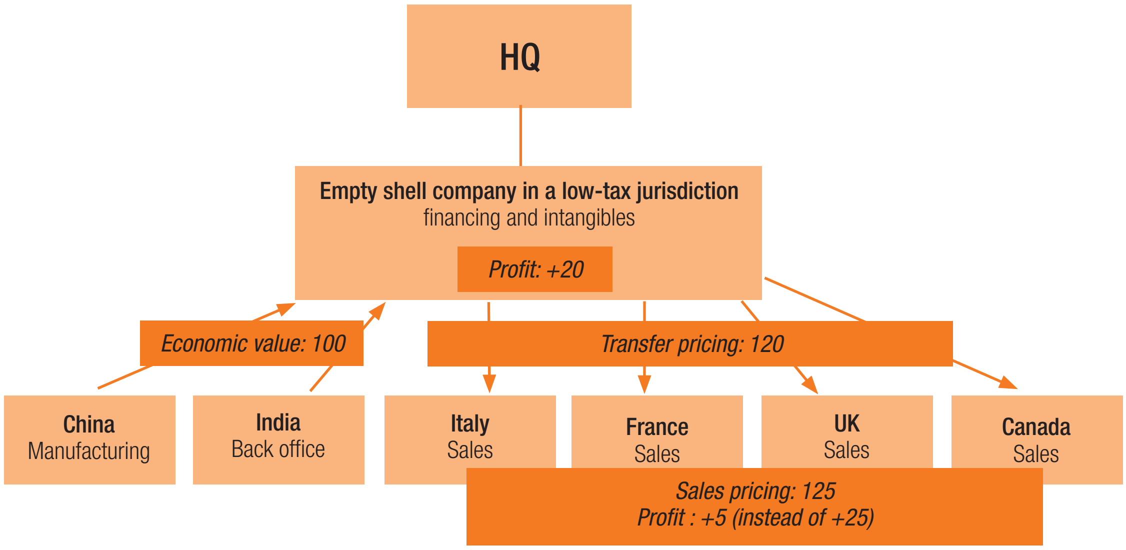
Manipulating intra group transfer pricing (Actions #8, #9 & #10)

Transfer pricing refers to the pricing of transactions within the same corporate group. Unlike transactions between two independent enterprises, transactions between subsidiaries within a MNE can be distorted so as to minimise profits in high-tax jurisdictions (typically where sales to the final consumer occurs) and maximise profits in low-tax jurisdictions (including tax havens).

The OECD Transfer Pricing Guidelines for Multinational Enterprises describe several pricing methods to avoid such distortion, all of which are based on the arm's length principle (which itself is founded on article 9 of the OECD Model Tax Convention). Central to the arm's length principle is the use of "comparability analysis" which values transactions within a MNE with reference to the conditions that would apply to two independent enterprises in "comparable transactions and comparable circumstances".

In Figure 3, production and services located in China and India are transferred to the European and Canadian subsidiaries (where sales take place) via the empty shell company. If the arm's length principle is not respected or is hard to apply (such as is the case for intangibles), there is a risk that the MNE will manipulate the pricing of each transaction: Chinese production and Indian services, the economic value of which is 100, are transferred from the empty shell company to the sales subsidiaries at 120, hence shifting +20 in profits from the latter to the empty shell company.

FIGURE 3: MANIPULATING TRANSFER PRICING

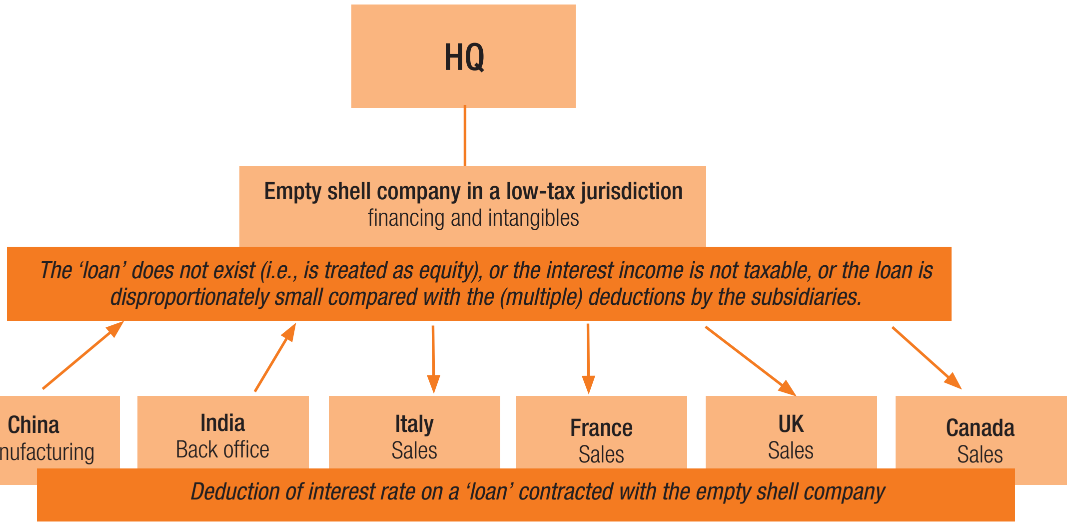


Deduction of debt interest and other payments (Actions #2 & #4)

Another key BEPS practice is the excessive use of deductible payments from the corporate income tax base of subsidiaries. A classic example is the deduction of debt interest from a loan with another entity within the MNE group. Interest payments are deducted from the subsidiaries but on the creditor side, the corresponding interest income is either taxed favourably, not taxed at all, or simply does not exist (i.e., case of a "hybrid mismatch" when the same source of financing is treated as debt in the jurisdiction of the subsidiary and as equity in the jurisdiction of the empty shell company).

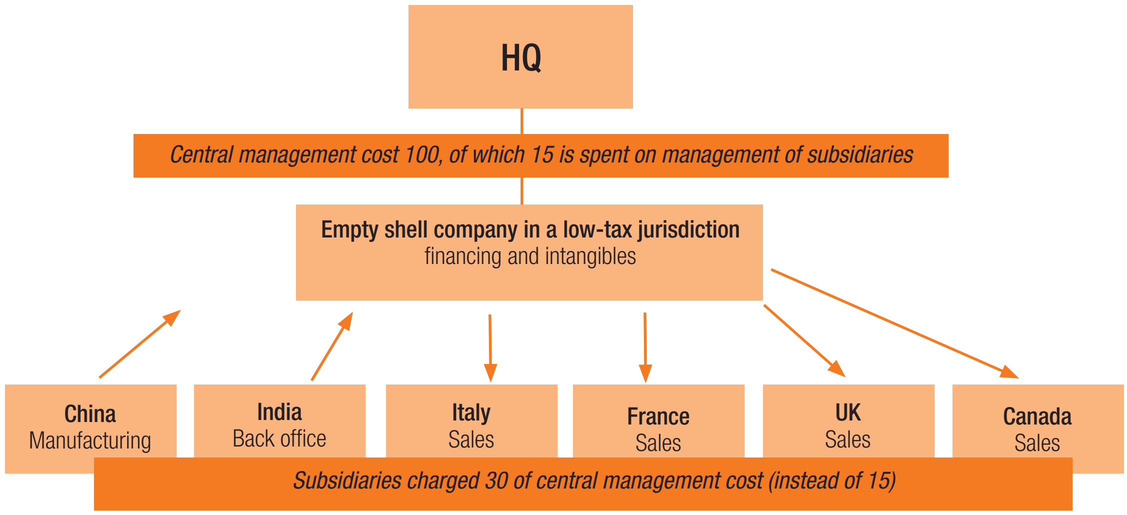
In Figure 4, the MNE subsidiaries are deducting debt interest from their respective corporate income tax bases based on a fictional loan from the principal empty shell company of the MNE.

FIGURE 4: EXCESSIVE DEDUCTIONS (DEBT INTEREST)



The problem of excessive use of deductible payments is not limited to loans and debt. Other forms of financial transfer can give rise to similar base erosion processes: intra-group insurance and guarantees on commercial and credit default risk and internal derivatives used in intra-bank dealings. Excessive deductions can also involve royalties and management costs at HQ level. In Figure 5 for example, the subsidiaries are overcharged for the management costs borne by the MNE headquarters – while the economic value is 15, they are paying 30.

FIGURE 5: EXCESSIVE DEDUCTIONS (MANAGEMENT COSTS)

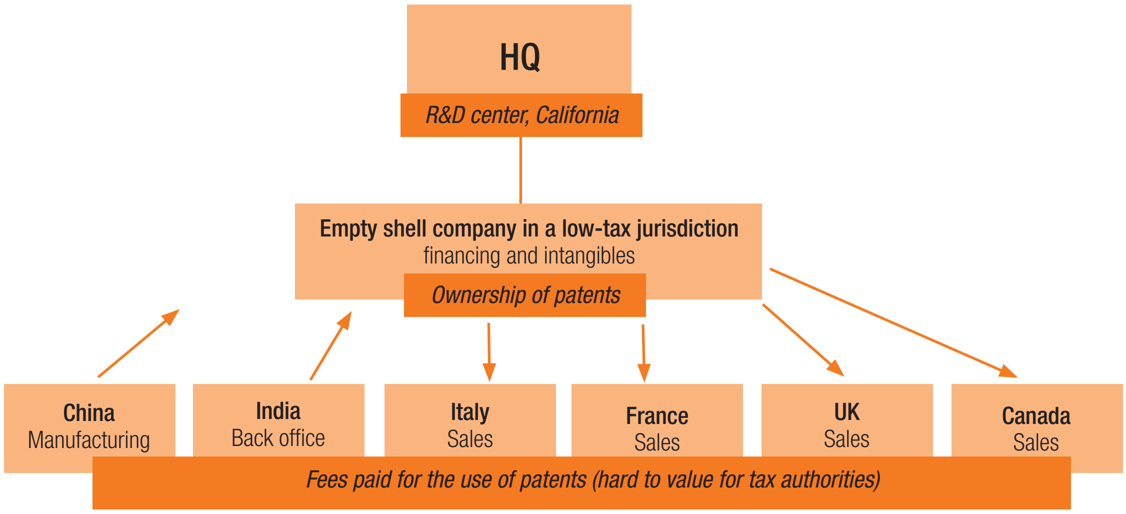


Intangibles (Actions #1 & #8)

The above examples have in common the shifting of taxable income from the economic activities that produce that income (the subsidiaries) to a low-tax jurisdiction (the empty shell company). These aggressive tax schemes become particularly hard to detect – and hence to deter – when they involve intangible assets (patents, royalties, R&D). That is why the OECD Action Plan pays so much attention to intangibles.

In Figure 6, the patent rights of Research and Development activities produced at the Headquarters of the MNE – say in Palo Alto, California State – are owned by the empty shell company – say in Ireland. The subsidiaries of the MNE pay a fee for the use of the patents. Aggressive tax planning then takes two forms: (i) profit shifting from California to Ireland and (ii) base erosion in the subsidiaries (when the fee paid is excessive compared to the value of the patent).

FIGURE 6: INTANGIBLES

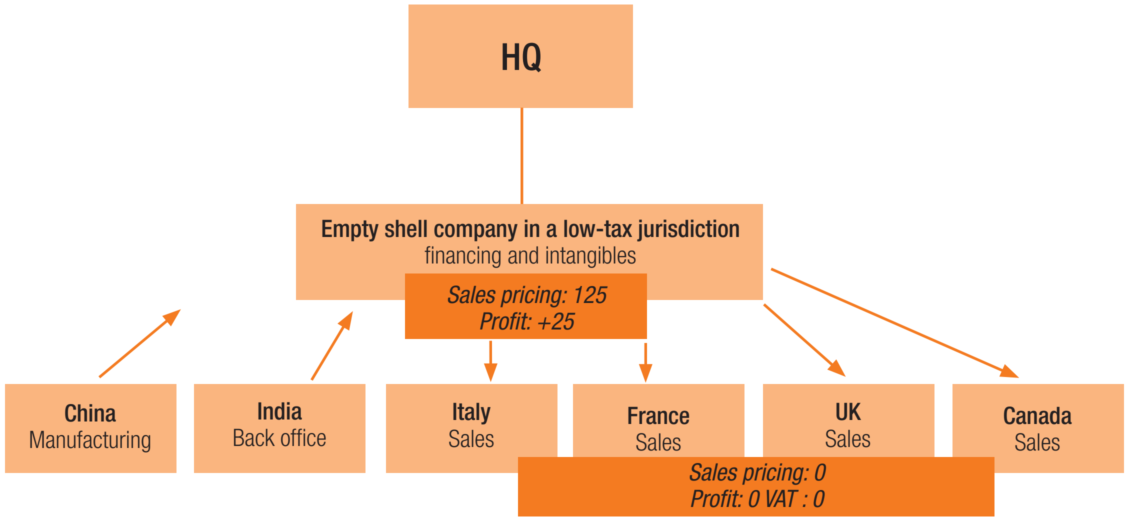


Transfer pricing of intangibles is particularly challenging for the OECD's "preferred" transaction pricing method based on the arm's length principle. Since intangibles are unique in nature, and hence in value, there is no market benchmark against which to conduct an objective comparability analysis. That is why the OECD Transfer Pricing Guidelines for Multinational Enterprises, revised in 2010, allow for the tax treatment of intangibles to depart from the market based arm's length principle and to use the "profit split method". The profit split method measures the combined profits of the two MNEs entities involved in the transfer and then split the profits between the two based on allocation keys – sales, staff, investment. As discussed below, NGOs and unions involved in aggressive tax planning campaigns have a strong preference for the profit split method, but one applied at group-level (not on a case-by-case approach).

Avoiding permanent establishment status (Action #7)

BEPS can also originate from the legal status of the subsidiaries. In the model MNE structure, the subsidiaries where sales take place (France, Italy, Canada, UK) act as "distributors" employing a sales-force that generate their own sales and profits. If on the other hand, subsidiaries act as "commissionaire", they do not have "permanent establishment" status in the country they operate: their sales force do not "sell" products or services themselves but take a commission on these sales which are contractually located in the empty shell company. In Figure 7, the MNE avoids the permanent establishment status in the countries where it sells products. Shifting the subsidiaries' status from distributor to commissionaire hence results in shifting profits out of the country in which the sales take place (but without any corresponding change in the economic substance of the subsidiaries).

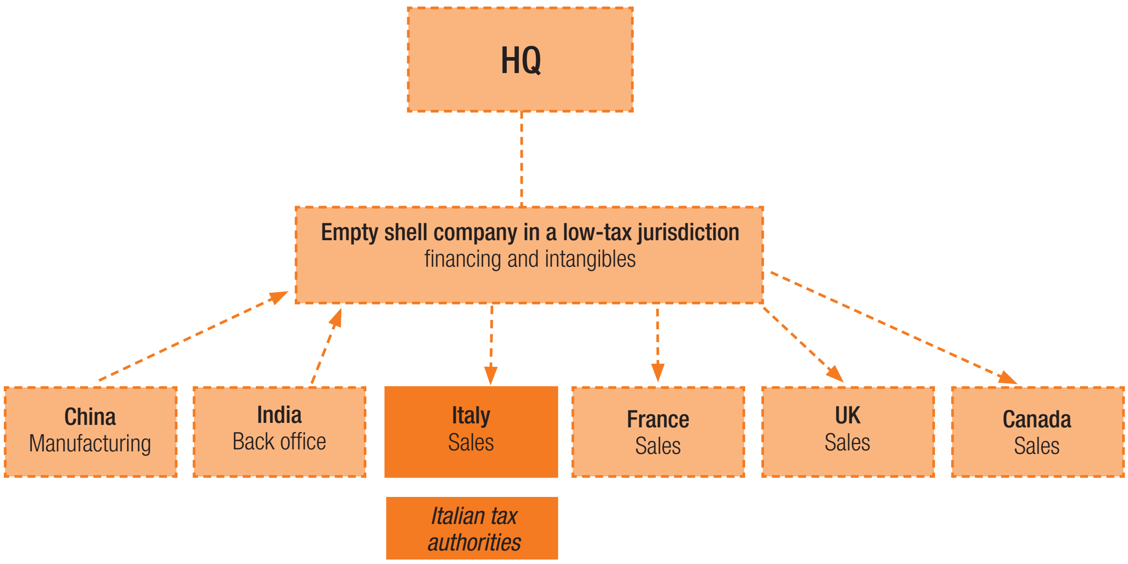
FIGURE 7: AVOIDING PERMANENT ESTABLISHMENT STATUS



Country-by-country reporting (Actions #12 & #13)

As the OECD argues "Tax administrations have little capability of developing a "big picture" view of a taxpayer's global value chain". As shown in Figure 8, the Italian tax authorities only have access to documentation relevant to the Italian subsidiary. The OECD Action Plan emphasises the need for greater corporate reporting to tax administrations (although "taking into consideration the compliance costs for business") and for such reporting to be delivered on a group-wide consolidated basis. Action #13 requires "MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template". In essence this is a requirement for country-by-country tax reporting, a central NGO campaigning objective, although at this stage the OECD only foresees such reporting to be made to tax authorities, not publicly.

FIGURE 8: WHAT A NATIONAL TAX AUTHORITY SEES



What is missing

The ITUC[7], TUAC[8] and the British TUC[9] welcomed the release of the Action Plan. It has the ambition to effectively curb aggressive corporate tax planning – but it needs to be effectively implemented. Reception was more measured on NGO side. For Oxfam, Christian Aid and other members of the Tax Justice Network, the BEPS Action Plan does not go far enough. It is "a step forward but fails poor countries" because, *inter alia*, it does not call for a radical shift in measuring transfer pricing (i.e., moving away from the OECD arm's length principle to a unitary formulary apportionment method or "unitary taxation") and because its fails to require public disclosure of country-by-country tax reporting. For the US-based Global Financial Integrity advocacy group, the OECD initiative lags behind because it "fails to endorse [publicly disclosed] country-by-country reporting" which is a "necessary precursor to curtail corporate tax dodging"[10].

On business side, the tone is very measured. The Confederation of British Industry (CBI) is reassured by the commitment that "administrative and compliance burdens on businesses will be taken on board"[11]. Deloitte stresses that the Action Plan "rules out fundamental change to the international tax architecture, such as the adoption of a global unitary tax system" but flags up "potential dangers, such as the possible misuse of confidential information" should country-by-country reporting to tax authorities become reality[12].

Country-by-country tax reporting and beneficial ownership

The OECD Action Plan would require country-by-country tax reporting to national tax authorities, but it should go further and require full public disclosure of tax paid locally, in line with recent reforms in the US and in the EU. The Dodd-Frank Act requires country-by-country tax disclosure but only for the oil, gas and mining companies. In the EU, the new Transparency and Accounting Directives enforce similar requirements for companies in the extractive sector[13]. The draft negotiated between the Council (i.e., Member States) and the European Parliament around the new Capital Requirement Directive IV for banks includes a mandatory disclosure by banks of their country-by-country positions, including tax payments.

Another missing element in the OECD Action Plan is the enforcement, by law, of disclosure of "beneficial ownership" of assets: that is access by authorities to the identity of ultimate owners of shares and other securities and assets. In many jurisdictions – and not just offshore tax havens – disclosure of beneficial ownership is still problematic.

7 http://www.ituc-csi.org/ituc-welcomes-oecd-action-plan-to?lang=en
8 http://www.tuac.org/en/public/e-docs/00/00/0D/40/document_news.phtml
9 http://www.tuc.org.uk/economy/tuc-22388-f0.cfm
10 http://www.gfintegrity.org/content/view/626/70/
11 http://www.cbi.org.uk/media-centre/press-releases/2013/07/cbi-responds-to-oecd-international-tax-action-plan/
12 http://www.deloitte.com/view/en_GX/global/services/tax/cross-border-tax/international-tax/1137f8684e7ff310VgnVCM2000003356f70aRCRD.htm# Ue-5-9K9mMq . A full selection of public
13 reactions can be found here: http://www.internationaltaxreview.com/Article/3234619/ITR-Premium-News-and-Analysis/The-OECDs-BEPS-report-How-did-others-react.html
http://ec.europa.eu/commission_2010-2014/barnier/headlines/speeches/2013/06/20130612_en.htm

Formulary apportionment method

NGOs are right to call for a radical shift away from the arm's length principle to a unitary taxation system. The fundamental problem with the arm's length principle is that it creates a fiction insofar as it treats entities of an MNE "*as if they were independent entities*" and does not treat the MNE as a single entity. The formulary apportionment has the great merit of considering an MNE for what it is: a single entity, not an aggregation of separate entities. As such it would eliminate a large part of current tax arbitrage opportunities and resolve most of the problems addressed by the Action Plan.

The OECD opposes the shift to a formulary apportionment method because it is "not a viable way forward", it is "unclear" what "behavioural changes" companies might adopt in response to the use of a formula, and because of the "practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries". The OECD, however, does not wholly reject the formulary approach: "special measures, either within or beyond the arm's length principle, may be required with respect to intangible assets, risk and over-capitalisation to address these flaws".

Transparency over dispute resolution mechanisms

Transparency over dispute resolution mechanisms is another sticking point. The Action Plan calls for facilitating the use of "mutual agreement procedure" between a tax authority and a MNE, thereby promoting private arbitration as opposed to traditional judicial procedure. For the Tax Justice Network "these procedures must become fully transparent and with publication of outcomes. There must be no secret deals when hundreds of millions of tax revenue dollars may be at stake. Publication would also improve the system, by establishing a record of the principles applied, to guide other taxpayers".

Impact on MNE workers

Last but not least, the Action Plan does not address the impact of aggressive tax planning on workers employed by the MNE, wherever contractual arrangements do not reflect the economic substance of the MNE structure. Central to this discussion is whether the profit shifting and tax base erosion schemes have an impact on the salary levels and collective bargaining of current and future workers. Another missing element is whether the opacity created by aggressive tax planning constitutes a barrier to workers' right to information and consultation about the MNE's business plan and foreseeable risk factors which is a legal requirement in many OECD countries. In this regard the development of specific guidance on the observance of the tax chapter (XI) of the OECD Guidelines for Multinational Enterprises would help holding business to account on their tax schemes.

It would also be important to address the extent to which workers' pension funds actively address the risk of BEPS through their shareholdings in listed assets, but also their business relationships with private funds, including hedge funds and private equity groups.

Institutional Investors' Shifting to the Long Term

The need for institutional investors to adopt long-term investment (hereafter LTI) strategies and in particular to increase portfolio "exposure" to infrastructure projects (incl. infrastructure, software, R&D, housing, energy & clean energy), has become central policy priority at the international level as seen at the last G20 Summit in St Petersburg, but also at the OECD, the Financial Stability Board (FSB, the forum through which G20 commitments on financial reform are to be implemented)[14] and the European Commission[15].

What is long-term investment?

A first question to address is what LTI means. There are two approaches: a positive list one (what LTI is) and a negative list approach (what it is not).

The FSB defines LTI as any financial asset which maturity exceeds five years and is invested in the productive capacity of the economy. The rationale of the FSB is that institutional investors (by opposition to banks) "will need to assume a greater role in this market", given "strains on government budgets and the weakened banking system". 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 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. To 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.

14 Financial regulatory factors affecting the availability of long-term investment finance – Report to G20 Finance Ministers and Central Bank Governors, 8 February 2013 http://www.financialstabilityboard.org/publications/r_130216a.pdf & Update on financial regulatory factors affecting the supply of long-term investment finance – Report to G20 Finance Ministers and Central Bank Governors, 29 August 2013 http://www.financialstabilityboard.org/publicat+ions/r_130829g.pdf

15.Green Paper on Long-Term Financing of the European Economy – COM/2013/0150 final – European Commission 25/03/2013 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52013DC0150:EN:NOT

A more qualitative approach prevails at the OECD and as outlined in the new G20 Principles. 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".

New G20 Principles on Long-Term Investment by Institutional Investors – a new tool for pension funds and policy makers to shift to the long term

The G20 High-Level Principles of Long-Term Investment Financing by Institutional Investors[16] set out preconditions to long-term investment for governments and investors to observe as well as specific requirements regarding the governance of asset owners, the accountability of asset managers, transparency and reporting along the entire investment chain, including informing and educating consumers.

If observed and implemented effectively, the G20 Principles could make a difference in helping workers' pension funds shift further, and as appropriate, toward long-term investment strategies. The G20 text is particularly welcome where it calls upon:

- Observance of other key social and environmental standards, such as the OECD Guidelines for Multinational Enterprises and the United Nations Principles for Responsible Investment (UN PRI) (Preamble)
- The development of "collectively organised long-term savings and retirement plans" to help mobilise investors for the long term (Principle 2.2)
- Defining long-term risks as including environmental, social and governance risks (3.4)

  "contract clauses of fund managers' and senior executives' remuneration" to be based on long-term, risk-return criteria (3.7)
- Any public support to private finance to be carried out on a cost-benefit analysis and "appropriately priced" (5.1)
- Disclosure "with sufficient granularity" by institutional investors on how they address long-term risks. (7.3, 7.4)

16 http://www.oecd.org/daf/fin/principles-long-term-investment-financing-institutional-investors.htm

Like the FSB, the OECD links LTI to the real economy ("productive capital), but it links "patient capital" not to the maturity of the asset (as the FSB does), but the holding period of the investor ("access illiquidity premia"). Importantly, it adds "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.

An alternative approach consists in defining LTI by what it is not. According to this approach LTI is needed to address the externality costs of short-termist and/or speculative behaviours. This approach – and one that is much favoured by international labour groups[17] – requires some acceptable definition of terms like "short termism", "financial speculation" and "financialisation" which can be challenging.

Ideally, LTI should be defined taking both approaches on board: (i) ensuring 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, 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.

The central role of pension funds

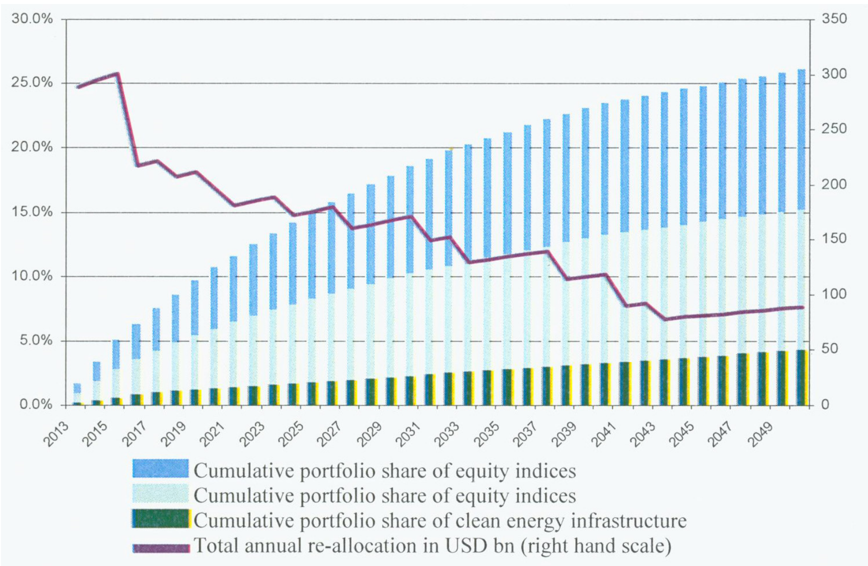
In the discussion on LTI by institutional investors, it is important to distinguish between "asset owners" (pension funds, insurance companies, sovereign wealth funds) and asset managers (asset management firms, bank asset management branches) and to give primacy to the former over the latter. That is 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 USD30tr assets under management – of which 90% are managed in developed economies –

17 "Speculation and Sovereign Debt – An Insidious Interaction" ITUC/TUAC discussion paper prepared by Gerald Epstein and Pierre Habbard, October 2011 http://www.tuac.org/en/public/e-docs/00/00/0C/74/document_doc.phtml

pension funds represent an important class of asset owners. Importantly pension funds 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 approach to LTI – shifting away from short-term to long-term investments, mainstreaming responsible investment practices, greater portfolio exposure to infrastructure and job creation projects.

The case of pension fund investment in climate change-related assets provides for a good example of how investors' potential could be unleashed for LTI. The long-term horizon of climate change finance happens to match the liability profile of pension funds. In reality, however, pension funds' exposure to climate change is limited today. Yet it would be theoretically possible to raise pension funds' investment in climate change-related assets to reach 5% of their total portfolio in a three-year period, thereby generating some USD300bn in annual flows in the first years after[18].

FIGURE 9: THEORETICAL PROJECTIONS OF PENSION FUNDS CUMULATIVE EXPOSURE TO CLIMATE FINANCE



The road to long-term investment

The potential of institutional investors to embrace an LTI strategy is there, clearly. But can it be unleashed? There are several challenges and barriers that would need to be addressed for that to happen. 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. Five years into the crisis, many pension funds across OECD are still struggling to meet minimum funding levels.

18 What role for pension funds in financing climate change policies? Joint TUAC - ITUC issues paper, May 2012 http://www.ituc-csi.org/what-role-for-pension-funds-in,12358.html & "The Role of Pension Funds in Financing Green Growth Initiatives", Della Croce, Kaminker and Stewart, OECD, Paris, 2011 www.oecd.org/dataoecd/17/30/49016671.pdf

The prolonged "quantitative easing" programme by central banks is also having unintended consequence on institutional investors with long-term liabilities. The low interest rate environment and the flattening of the curve (long interest rates are normally higher than short term rates) is a good thing for banks because they are highly dependent on short term funding. It is a bad one, however, for investors with long-term liabilities such as insurance companies and pension funds. The resulting low interest rate environment may then in turn push investors in a "search for yields" increasing exposure to high returns, but high risk investment strategies.

Barriers to LTI are also to be found in inconsistent policy and regulatory frameworks. The most obvious case of lack of policy coherence is clean energy. For a first, there is a lack of marketable products that meet the scale and liquidity requirements for institutional investors to shift toward clean energy investing. The green bond market value is estimated at USD16bn compared with the +USD95tr world bond markets, while annual green bond issuances (i.e., the net inflows) are in the range of USD1-2bn (compared with some USD6tr issued worldwide). More fundamentally, as long as policymakers will let fossil fuels 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 price on carbon emissions, and hence on the comparative financial returns of clean energy.

The post-crisis wave of financial reforms – as legitimate as may be from a financial integrity and stability perspective – may also have had some unintended consequences on investors' capacity to shift toward greater LTI strategy. The need to limit both risk-taking behaviours and leverage levels in the financial sector could indeed hamper the capacity of institutional investors to re-allocate money to LTI-oriented assets. LTI projects such as infrastructure and climate change mitigation entail a higher level of risk than comparable non-LTI, non-infrastructure or non-climate related investments (due to the use of recent or unproven technologies, uncertainty and inconsistency of regulations and policies, cross-border investment risks). The problem of risk rating is also acute for financing long-term infrastructure in developing countries. According to a report commissioned by the G20, lack of information and the "disconnect" between sovereign risk captured by the financial markets and the effective "business risk" in lower-income countries and in lower middle-income countries leads to a lower level of funding and to a higher cost of financing than what would apply otherwise[19].

The concerns about the unintended consequences of post-crisis financial reforms have been exploited, if not manipulated, by opponents to reforms. Bankers in particular have exaggerated the impact of the new Basel III prudential framework. Yet policymakers and 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 distinction is possible in theory but it is not at government and policymaker level[20].

19 "Misperception of Risk and Return in Low Income Countries - Innovative Finance Serving Infrastructure Development: a Win-Win Deal", Roland Berger Strategy Consultants, G20, Los Cabos, June 2012

20 "The Risk-Reward Nexus", William Lazonick & Mariana Mazzucato, Policy network, November 2012 http://www.policy-network.net/publications/4295/The-Risk-Reward-Nexus

Further down the investment chain, it would also be appropriate for issuers (listed or private companies) to observe long-term reporting requirements and to disclose and report on key environmental, social and governance (ESG) performance and impact, making sure that the right information is available to investors regarding responsible LTI. And we are still far away from mainstreaming ESG reporting.

Leadership by asset owners, accountability of asset managers

Finally, for LTI to take place, there needs to be strong asset management accountability. And to that end 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; they want to sell their own products and investment strategy to their clients (asset owners). Unlike asset owners they are not bound by long-term liabilities and therefore have no structural incentive to engage in LTI.

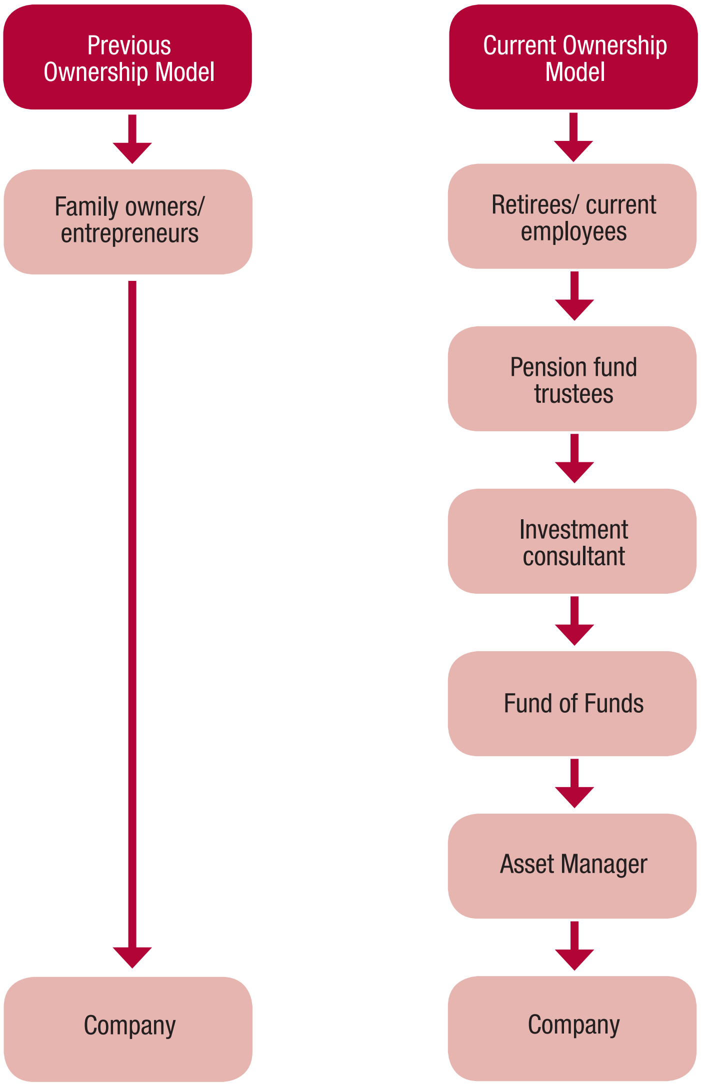
Yet, asset owners are not visible in the policy debate about the structural shortage of long-term capital[21]. In the case of pension funds, leadership requires board independence that prevents conflicts of interest with asset managers and other financial service providers. That in turn requires accountability to members of the pension schemes through member-nominated trustees. It is no hazard that all pension fund leaders in investing in clean energy have pension member and worker representatives on their board.

Asset owner leadership also requires confidence in the board room. This 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 – be explicitly taken on board.

If the lack of asset owner leadership has become an issue, it is also because of a decade-long lengthening of the "investment chain" between the asset owner and the owned asset. The multiplication of intermediaries (asset managers and the many consultancies that swirl around) is creating major complications for asset owners who wish to ensure proper accountability of how their moneys are being invested. A lot of recent literature points out to these problems, not least in the UK[22].

21 Asset owners invisible in capital debate, 6 September 2013 http://www.top1000funds.com/conversation/2013/09/06/asset-owners-invisible-in-long-term-capital-debate/
22 -The Kay review of UK equity markets and long-term decision making: final report. Department for Business, Innovation & Skills, 23 July 2012 https://www.gov.uk/government/publications/the-kay-review-of-uk-equity-markets-and-long-term-decision-making-final-report

FIGURE 10: THE LENGTHENING OF THE INVESTMENT CHAIN



What needs to be done? For a first 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 over portfolio performance. Such long-term metrics should naturally tone down the importance of quarterly (three-month) performance benchmark. That is rarely the case, or it is only become an emerging best practice. Ensuring 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.

Shareholders' rights should have some meaningful impact on the CEO and the board of directors, including the right to propose resolution on 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 – as is the case of activist hedge funds engaging in "rampant takeovers".

The challenge for regulators is to avoid the two objectives – promoting shareholder rights for LTI and curbing those same rights to prevent speculative behaviours from happening – from becoming mutually exclusive. In a positive list approach, some countries grant additional voting rights to long-term shareholders. 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.

The level of concentration of the financial sector may also create structural challenges to asset management accountability. 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 as "too-big-to-fail" by the G20 and the Financial Stability Board and of global insurance companies. 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 the 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 over group-wide business relationship and strict rules to prevent conflicts of interest can help of course. But since the risk of conflicts of interest is structural in nature, the ultimate solution might need to be structural as well. This in turns brings new light to the on-going debate on the need to enforce, by law, the separation of retail commercial banking from the speculative and volatile investment and trading activities.

But do we really want this to happen?

Assuming that all the above would come into effect, would achieving a full LTI agenda for institutional investors still be a desirable outcome in the end? Could the costs outweigh the benefits?

In the short and medium term, considering the regulatory challenges ahead and the time for transition to an LTI-friendly policy and regulatory environment to take place, public financial support to investors would still be needed. The most common form of support is a government guarantee on the credit default risk of an asset. With a few notable exceptions, all green bond issuances to date have been accompanied by explicit guarantees by governments, by regional development banks or by the World Bank. Government support can take other forms: subsidised low-interest direct loans, export credit insurance and facilities, foreign exchange risk insurance and subsidised support services to investment deals. Government-funded/run venture capital fund 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 is a delicate policy issue. These massive public guarantees benefiting bankers have in effect transformed the entire industry into a publicly subsidised business. Andrew Haldane of the Bank England estimates that the explicit and "implicit" public guarantees represented a net saving of some USD160bn in 2009 for 13 banks in the UK alone.

Public support to private finance therefore 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 public interest (i.e., avoiding "privatising gains and socialising losses") but also to avoid unfair competition in the financial sector.

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 for example could well end up in working against the much needed protection of public services, particularly in developing countries. This is particularly true for Public-Private Partnerships (PPP) whose model of financing is being actively promoted. PPPs account for less than 15% of total asset value of public sector infrastructure investments but they are on the rising. Yet the suggestion that PPP should be considered as a preferred option for financing infrastructure in favour of traditional public procurement does not hold. 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, while losses are socialised. In contrast to traditional public procurement, PPPs have many hidden costs and are excessively complex contracts for governments to handle.

The road ahead

The road to shifting institutional investors toward long-term investment strategy may at first sight look as one big highway. It would all make sense, not least because of the long-term liability profile of investors, and of pension funds in particular, and importantly because it would help divert investors away from short-termist speculative behaviours. But the caveats are many. The crucial challenge is to restore accountability along the investment chain, and to rebalance the power relationship between asset owner and asset managers, together with strong reporting requirements. Financial regulation and prudential norms should to the extent possible help distinguish between "good" and "bad" forms of risk. Yet from a progressive perspective, that one that is shared by the labour movement and civil society groups, there are crossroads on the way 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, not substitute, to citizens' right to public services and to effective government institutions.

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23 "The $100 billion question", Comments by Andrew Haldane, Executive Director, Financial Stability, Bank of England, at the Institute of Regulation & Risk, Hong Kong, March 2010, BIS Review 40/2010 http://www.bis.org/review/r100406d.pdf

24 "PPPs – In pursuit of fair risk sharing and value for the people?", TUAC, April 2010 http://www.tuac.org/en/public/e-docs/00/00/06/FE/document_doc.phtml

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