



Strengthening the role of long-term investors

The crucial role of long-term investors is at risk –
Eight fact sheets on issues and challenges



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Profound changes are underway in the regulation of the financial sector. Given these dynamics and the challenging economic environment, it is essential that the role of long-term investors be strengthened, not weakened. Long-term investors are essential for the real economy as providers of risk capital – but also for the financial markets as stabilisers and shock absorbers.

Foreword

Five years after the onset of the global financial crisis, policy actions have contributed to lower financial stress and more stable macroeconomic conditions. Looking ahead, however, the global economic outlook remains uncertain, with much of the regulatory reform agenda continuing to evolve – and with it the financial market system. Deleveraging remains a key longer-term factor not only in the financial sector but also in the public sector. To restore long-term growth and wealth creation, public and private market leaders need to increase efforts to make the financial system more resilient.

During this important process, the stabilising role of long-term investors needs to be duly taken into account to make financial markets more resilient and to provide the long-term funding which is needed for sustained growth. As they are able to provide risk capital to the real economy and are invested with a longer-term time horizon, they provide significant benefits to both the global economy and financial market stability. To this end, the Institute of International Finance (IIF)'s Council for Asset and Investment Management (CAIM), chaired by Swiss Re, was established in March 2012. Its mandate is to analyse and address issues and challenges for long-term investment and asset allocation decisions arising from both market dynamics and regulatory reforms.

The IIF CAIM provides the long-term investment community with a structured forum to discuss market challenges and their implications. Its members represent a growing community voice with currently almost USD 20 trillion in assets under management.

Long-term investors should not be made “short-sighted”; rather, their role should be strengthened, particularly given today’s economic realities, which are unlikely to change unless decisive policy action is taken.

While the following issues have been and will continue to be within the remit of CAIM, the views expressed in these short notes do not necessarily represent those of all CAIM members. As with so many challenges today, there are many valid approaches. The biggest risk of failure, however, is inaction. In this light, we hope you will find the set of topics and perspectives shared in this publication stimulating and useful.



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Financial repression

Key messages

- Financial repression can lead to lower nominal interest rates and potentially higher inflation (which could lead to negative real interest rates), punishing savers and rewarding borrowers.
- The very accommodative monetary policy together with regulatory forces favours government bonds and distorts the bond price formation process.
- Financial repression has also led to increases in financial institutions' exposure to sovereign debt.
- Financial repression in the context of deleveraging (both public and private sector) and regulatory reforms have weakened the traditional re-intermediation role of long-term investors.

Issue

Financial repression – ie policies that direct funds to governments that could otherwise go to other borrowers – has historically been used as a way to allow governments to borrow more. A key means of financial repression is encouraging financial institutions to hold more sovereign bonds, thus leading to lower bond yields. These lower borrowing costs provide governments with the means and incentive to add new debt – potentially to above sustainable levels. Regulatory reforms favoring sovereign debt (eg, in Basel III, Solvency II and UK bank liquidity requirements) are an important channel of financial repression, as is encouraging or mandating domestic pension funds to shift asset allocation in favor of domestic government bonds. Government bond yields are also being kept at low levels through massive government bond purchases from central banks

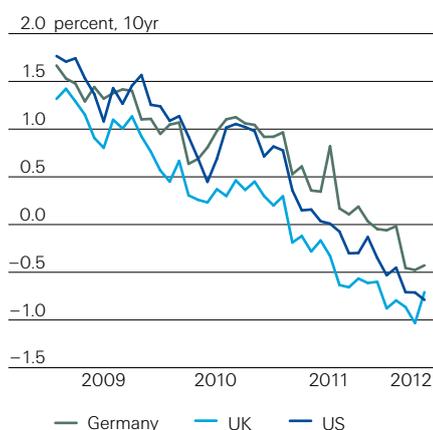
public balance sheets has increased from 15% to 35% recently (see Chart 2). With the substantial market interventions of public institutions and record-low policy rates over a protracted period, the current bond price formation process is interrupted. Furthermore, both Basel III for the banking industry and Solvency II for the insurance industry favour the allocation of assets to sovereign bonds. These factors have led to a possible underpricing of sovereign risk. Additionally, financial repression has also led to increases in financial institutions' exposure to sovereign debt, making them more vulnerable to adverse interest rate shocks.

Long-term investor perspective

Central bank action and regulatory changes keep real interest rates at lower levels than they would be otherwise. The resulting distortion of the current bond price formation process and the artificial demand for government bonds call into question the price signalling role of financial markets for the real economy. Indeed, the current record-low interest rates (negative in real terms for many major mature economies) arguably reflect in part the extent of financial repression at present. While record-low policy rates are helpful in supporting the economic recovery, the regulatory efforts underway act in a similar manner to lower sovereign bond yields through their asset allocation implications for long-term investors. If policymakers succeed in minimizing the adverse effects of financial repression by creating the right incentives for long-term investors, more funds could be channelled to productive areas of the real economy. Towards that end, the role of long-term investors should be strengthened, enabling them to best play their intermediation role in a deleveraging world.

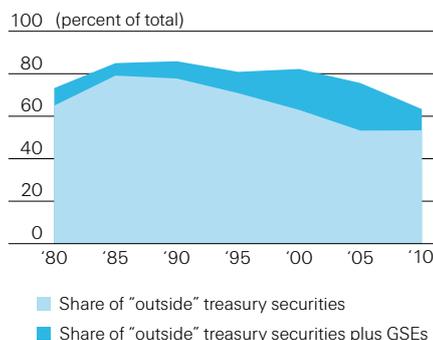
As such, additional empirical evidence on the specific impact of financial repression on long-term investors can be useful. Also, estimating the current size of the financial repression tax (ie as % of GDP) would provide a new perspective on the issue and add value to the ongoing debate.

Real interest rates



Source: Bloomberg

US treasury buyers



Source: Reinhart, Kirkegaard and Sbrancia (June 2011)

Financial repression can also act to chip away at a government's debt burden – by keeping government bond yields low, interest expense is reduced. This can help lower deficits (if interest expense is a major component of government deficits), thus slowing the rate of debt accumulation. Moreover, if inflation were to increase as a consequence of the stimulative effect of lower interest rates, the debt burden (and debt-to-GDP ratio) would also be reduced. However, the risk of sovereign "over-borrowing" can still easily outweigh the potential benefits of a lower debt burden in these cases.

Broad implications

If financial repression leads to negative real interest rates by lowering nominal interest rates and/or increasing inflation, it can effectively be viewed as a tax, ie a transfer from creditors (savers and end-users such as pensioners) to borrowers. Such a tax, however, is much more subtle than direct taxation, and is determined by financial regulations and inflation performance. Real rates are currently negative in many advanced economies (see Chart 1). The share of treasury securities held on

Sources: Reinhart, Kirkegaard and Sbrancia, Financial Repression Redux, June 2011

Regulatory reforms

Key messages

- Important regulatory reforms such as Basel III and Solvency II are underway. It is critical that regulatory reforms strengthen the role of long-term investors, enabling them to best play their intermediation function in providing risk capital to the economy at large and stabilise markets by remaining invested.
- Macro-prudential policy should be more countercyclical and encourage prudent risk taking.
- Regulatory reforms may cause unintended consequences such as convergence in global asset allocation.
- The extension of the FSB (banking driven) approach and its methodology to other sectors without due consideration of the specificities of these sectors should be avoided.

Issue

A major focus of the current process of regulatory reform is on addressing the overall systemic risk in financial markets and the “too big to fail” issue. Some of the newly introduced measures are additional capital charges for global systemically important banks (G-SIBs) and resolution regimes for systemically important financial institutions (SIFIs). In addition, new risk-based regulatory reforms for banks and insurers (Basel III, Solvency II) are being finalized and implemented. Among others, new regulatory initiatives for insurers will gradually include reforms on group supervision (eg IAIS ComFrame), on solvency (eg Solvency II, NAIC solvency modernisation initiative) and the development of an assessment methodology for the identification of potential global systemically important insurers (G-SIIs) and related policy measures.

Broad implications

Regulatory changes are needed to ensure a more stable and less pro-cyclical financial system. However, rigid policy measures mandating specific business models and structures, such as the Volcker rule¹ in the US, the Vickers proposal² in the UK and the Liikanen report for the EU may individually and in aggregate be detrimental to the efficient functioning of domestic and global financial intermediation. Moreover, in times of recession and with capital being a scarce resource, regulatory reforms may also have unintended consequences. For example, the IMF in its September 2011 Global Financial Stability Report points out that regulatory initiatives may have significant effects on the asset allocation of institutional investors, such as causing a shift from equity investments to “safer” fixed income securities – which could make it much more costly for banks to attract equity capital. In addition, increasing regulatory pressure could also foster the use of alternative ways of financing, which may be less transparent and less well-regulated.

Long-term investor perspective

The implementation of new regulations is challenging, costly, and often not well coordinated. In addition, any legislative action for a certain sector (banking, insurance, pension funds, etc.) directly or indirectly affects all other sectors on a global scale due to the growing integration of financial markets. Consequently, a balanced approach is needed considering all stakeholders’ perspectives as well as the indirect impact of regulation on the real economy. However, there is no common architecture or vision among policy-makers and most changes and discussions are made in silos which may lead to unintended consequences (eg extraterritoriality, cross-sectoral impacts). As an example, the traditional stabilising role of long-term investors will likely be weakened in the course of current reforms, due to changes in attributed risk for certain asset classes (eg higher capital requirements for infrastructure investments and private sector bonds under Solvency II).

Avoiding another major financial crisis is in the best interest of all stakeholders. However, designing a new regulatory framework is an extremely complex task with many possible unintended consequences. Collateral damage can be reduced by providing a clear and comprehensive vision. More concretely, this can be supported through further work on cumulative and cross-sectoral impact studies and conducting empirical research in this area. In this regard, the IIF published an initial report on the Specific Impacts of Regulatory Change on End-Users in October 2012. In conclusion, while reforms across sectors need not necessarily be harmonised, cross-sectoral coordination of regulatory reforms should receive high priority.

¹ The Volcker rule is aimed at restoring confidence in the US financial sector to prevent further crises. This includes the proposal to limit certain risk taking activities by banks (such as proprietary trading)

² The Vickers rule is aimed at limiting the damage banks can do to the financial system by ring fencing the private and commercial banking activities

Need for long-duration assets

Key messages

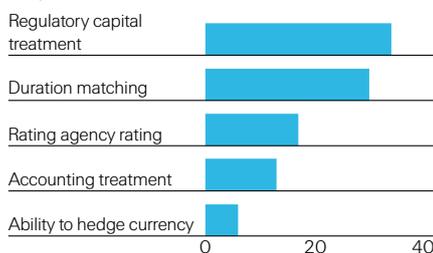
- Global asset allocation trends have a significant impact on the financial industry and market functioning.
- The scarcity of available long-term funding is neither in the interest of the financial industry nor of the real economy and society at large.
- Consequently, policy makers should provide incentives for institutional investors to increase provision of long-term funding to the economy.

Global institutional asset allocation

Asset allocation by asset class percent	Asset managers			Pension funds		
	2006	2008	2010	2006	2008	2010
Cash	6.9	8.9	6.5	1.7	2.1	2.4
Equities	39.7	31.2	34.5	51.4	40.3	44.9
Bonds	41.9	46.6	46.7	36.0	41.9	37.1
Alternative assets	11.5	13.3	12.3	10.9	15.7	15.6

Source: IMF, GFSR 2011 report

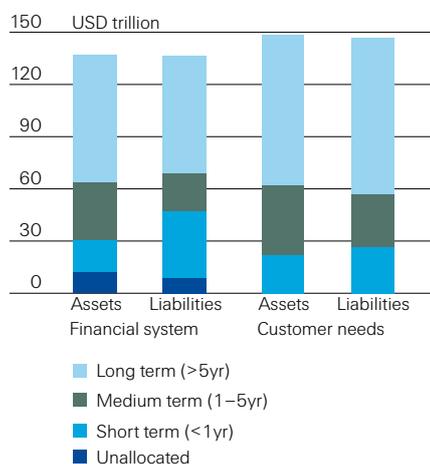
Importance of non-investment risk of global insurers in %



Source: GS insurance survey, 2012

Maturity breakdown

Comparison of maturity breakdown



Source: Oliver Wyman, 2012

Issue

Long-term oriented investors are increasingly facing a variety of constraints due to both overall financial market developments and regulatory changes. These have an impact on the asset allocation of investors, which can change significantly over time (see Chart 1). It is notable also that the regulatory capital treatment is now seen as the biggest non-investment risk (see Chart 2).

On the one hand, market developments and regulatory changes may create "short-sighted" investment decisions and convergence in global asset allocation. On the other hand, global demographic trends and the industrialisation of emerging markets increase the need for long-term investment in project financing. As a result, balance sheets of financial intermediaries fail to match the aggregate of customer needs (see Chart 3), with the term of liabilities in the financial system being shorter than it should be.

According to the consulting group Oliver Wyman, the available long-term funding capacity is about 20% less than the aggregated desired consumer long-term commitments. More specifically, the duration mismatch in the banking industry is estimated at around +5 years and about -5 to -15 years in the insurance and pension industry (as the latter perform a reverse maturity transformation because they invest shorter term than their liabilities).

Broad implications

While regulatory changes are necessary after the past financial crisis and macro imbalances, current regulatory reforms may decrease the preparedness of financial market participants to invest in long-term assets. While Basel III will impact the ability of banks to fund long-term investments, Solvency II is likely to reduce institutional investors' capacity to finance the real economy through long-term capital. It remains questionable whether other long-term investors can fill this gap for a sustained economic growth. In other words, savers make commitments that are shorter than would be optimal. This may subsequently lead to social costs in the form of reduced GDP growth, which Oliver Wyman puts in the region of some 0.75% per annum over a 30 year period.

Long-term investor perspective

The available long-term funding to the real economy is not high enough to optimally meet consumer needs. The restrictions faced by institutional investors to make long-term commitments further exacerbate this mismatch, representing a drag on GDP growth.

The lack of long-term capital helps neither financial market stability nor the real economy. The right policy incentives must be created in order to change institutional investors' asset allocation behaviour.

Aligning financial intermediaries' balance sheets with overall consumer needs is crucial in order to better support real economic growth. In actively shaping the debate around these issues, policymakers can add value. Also, additional research can be useful in providing empirical evidence on the resulting social and economic costs from the "duration mismatch" described above. Finally, proposals on how to incentivise institutional investors to provide long-term capital to the real economy would be of particular interest.

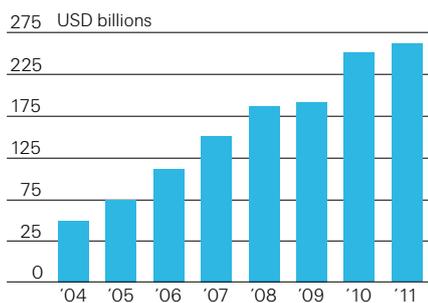
Sources: Oliver Wyman, The Real Financial Crisis: Why Financial Intermediation Is Failing, 2012; IMF, GFSR, Chapter 2, Sept 2011; Goldman Sachs, Seeking Return in an Adverse Environment, July 2012; PIMCO, The New Normal in Insurance Asset Management and The Impact of Solvency II, Sept 2011

Infrastructure

Key messages

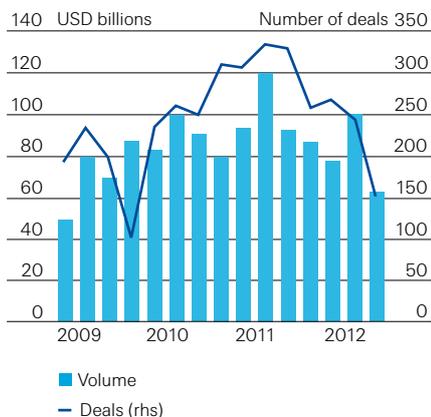
- Very large investments are needed in the infrastructure sector for maintenance, replacement and new build-ups (eg in the energy sector including renewable energy).
- However, the current regulatory framework is often not supportive and weakens the incentive to invest in the infrastructure sector.
- There is a clear need for more infrastructure investments from the private sector. While developed countries need to finance the maintenance, upgrade and the building of new infrastructure, emerging markets have to focus mostly on the latter.

Total new investment in clean energy technology



Source: Bloomberg New Energy Finance

Global project finance volume



Source: Dealogic, 2012

Issue

In any economy, infrastructure construction is a key pillar to increase production and productivity over the long term. However, in times of prolonged recession, where the economy is in particular need of longer-term investments, regulations are forcing traditional holders of long-term investments to reduce their exposures¹ breaking the traditional intermediation of project financing. As an example, higher capital and liquidity (eg net stable funding ratio) requirements limit banks' capacity to fund long-term infrastructure investment. While recent adjustments to the Basel III liquidity coverage ratio (LCR) should help free up some capacity for this type of investment, major concerns remain.

Developed countries must upgrade and maintain their infrastructure. The European Union alone is in need of around EUR 2 trillion² for transportation, energy and information, communication, and technology (ICT) investments over the next decade. Likewise, emerging markets need to extend their infrastructure significantly in order to support their development over the long term. In addition, achieving a shift to a low carbon economy requires cumulative global investment in green infrastructure (eg renewable energy – see Chart 1) of about USD 36–42 trillion between 2012 and 2030, or some USD 2 trillion or 2% of global GDP per year; only USD 1 trillion is invested annually at present³. However, due to the nature (legal and structure) of the financing instruments (loans), accessing these types of investment remains difficult for non-banks.

Broad implications

Historically, infrastructure investments supply has been countercyclical. Governments previously launched stimulus packages especially in times of crisis to “kickstart” the economy. However, the funding available to governments for infrastructure is diminishing. States and banks are deleveraging at the same time in all major economies. As a consequence, the number of global project financing deals may continue to fall (see Chart 2) – producing a long-term negative drag on the economy.

Long-term investor perspective

For non-traditional project finance investors (such as liabilities driven pension funds and insurance companies), entering the infrastructure market presents challenges from the market as well as from the regulatory side. In fact, current instruments are not flexible and supportive of ALM investing because of their lack of liquidity, low credit rating, and lack of duration (floating coupon). In addition, these inherently long-term assets are penalised by Solvency II as their decreasing default profile over time (unlike normal bonds) is not considered. Consequently, given that investing in infrastructure is necessary and crucial for the economic development, a better alignment of “old” and “new” stakeholder interests (public, private) is necessary.

There is a need to improve several aspects to ensure that more institutional investors can participate in this market (eg by reducing capital charges, creating investable indexes, giving tax incentives, providing fixed rate products). All of these changes should be made taking into account the social, environmental and economic aspects of infrastructure investments. In addition, the creation of a fully-fledged bond market for infrastructure financing will also increase the ease of investor participation, thus fostering future growth in this sector as well in as the overall economy.

¹ The BIS, in its quarterly review of March 2012 anticipated that EU banks should cut about EUR 40bn in their loan portfolios and sell about EUR 75bn of assets in order to reach an early implementation of certain aspects of the Basel regulations.

² European Commission, Europe 2020 Project Bond Initiative

³ B20 Task Force Recommendations on Green Growth, 2012

Sources: “Project Finance Review”, Dealogic, First Nine Months 2012; “Global infrastructure crisis”, Deloitte 2008; “Driving the launching of financial markets dedicated to the long-term asset class, Eurofi 2012; B20 Task Force Recommendations on Green Growth, 2012; Bloomberg New Energy Finance

Low interest rates

Key messages

- Policy rates and core sovereign bond yields are currently at record low levels with the risk of side effects (eg excessive risk-taking and inflation) being more imminent than ever.
- Further, low interest rates lead to a massive shift from savers to borrowers.
- The risks could spill over to other countries, especially to emerging markets.
- Such implications could offset the advantages of accommodative monetary policy and could significantly hurt long-term investors.

Issue

Central banks around the world have eased monetary policy to spur economic activity by cutting interest rates (Chart 1). However, although low interest rates may help boost the economy by incentivising consumption and thus increasing aggregate demand, extended periods of low interest rates bear significant risks which in turn could offset the intended positive effects from policy easing measures.

Broad implications

Apart from the potential threat of rising inflation, prolonged periods of low interest rates can encourage financial institutions to take on more risk (see IMF in its October Global Financial Stability Report, October 2012). The reasons for this are several: I) Low interest rates lead to a decline in bank profits as net interest margins decline. Consequently, banks try to offset the losses by increasing their activities in non-interest bearing fields such as trading or securitisation. II) As low interest rates lead to higher liability valuations and lower returns, insurance companies are forced to search for higher yielding and consequently riskier investment opportunities to be able to cover their contractually fixed liabilities. III) Low discount rates and core government bond rates may drive up asset prices and, if such assets are used as collateral, this could encourage riskier lending (eg in the real estate sector). Ultimately, this could lead to higher rates of non-performing loans and impaired assets.

In addition to excessive risk taking, low interest rates may also have an unwanted side effect on emerging markets as capital in- and outflows from investors on the search for higher yields can drive up asset prices and create inflationary pressure, and consequently cause an appreciation of the local currency.

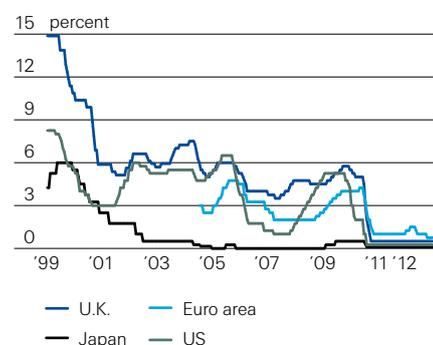
Moreover, extended periods of low interest rates also have longer-term negative macroeconomic effects: Such periods incentivise companies to delay the need- ed deleveraging and can create asset bubbles through carry trades.

Long-term investor perspective

The longer the period of low interest rates, the greater the risk of negative side effects. As noted earlier, “financial repression” can increase financial institutions’ exposure to sovereign debt – making them more vulnerable to adverse interest rate shocks (for example see Chart 2). Thus, hiking policy rates bears risks as well. It is crucial to take these risks into account when potential easing measures or their reversals are assessed.

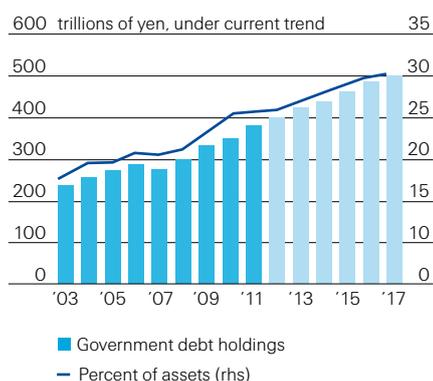
While an accommodative monetary policy stance is needed during economic downturns, prolonged periods of low interest rates can represent a threat to financial market stability. Hence, monitoring the impact of low interest rates and addressing related issues is crucial to maintaining well-functioning financial and macroeconomic systems. Policymakers’ attention should be raised by addressing the long-term investors’ views on low interest rates. This could be done via an empirical assessment of the impact of “financial repression” and initiating high-level policy dialogue (see also page 4).

G4 policy rates



Source: IIF, AMIC Background Note Sept 18 2012

Japanese bank holdings of government debt to 2017



Source: IMF, Global Financial Stability Report (Oct 2012)

Sources: IMF, Global Financial Stability Report, Oct 2012; BIS, 80th Annual Report, Low interest rates: do the risks outweigh the rewards, June 2010; WSJ, Barley R., Persistently Low Rates Carry Risk Of Negative Side Effect, January 2012; IIF, AMIC Background Note, Sept 2012; Swiss Re, Facing the Interest Rate Challenge, sigma 4/2012.

Demographics

Key messages

- Demographic factors will influence asset allocation in most countries over the next decade.
- Age-related spending will rise.
- For longevity, new risk transfer solutions have to be developed to help ensure that living longer stays a financially secure experience.
- A rapidly ageing population will affect both public (eg “welfare states”) and private institutions (eg underfunded pension funds).
- Pressure on policymakers will mount to address bigger pension and healthcare bills. Taxes may have to increase as a consequence.

Issue

Ageing – and related topics such as longevity risk and health markets – is likely to be a very significant topic among market participants in the coming years. While developed markets have already fully benefited from their demographic dividend¹, emerging markets will be following suit (China as early as 2015). The world is ageing rapidly. According to UN estimates, the cohort of people above 50 years old is likely to increase from 1.4 billion in 2010 to about 4 billion over the next century (see Chart 1), while the population of young people (Age 0–19) is expected to stay largely stable during that period (see Chart 2). Achieving longer lifespans presents society with the critical challenge of ensuring that all individuals have an adequate and funded income throughout their old age, or otherwise adapting the social welfare state.

on the working population. This may not only cause economic growth to slow down but also current fiscal deficits to worsen. Also, both financial institutions and governments will be affected. As an example, pension funds, which are already struggling to deliver sufficient returns in the current low yield environment, will be affected by the increasing amounts of unfunded liabilities. Also, retired investors may draw more of their savings which may put downward pressure on equity and property prices.

Demographics warrant close attention by policymakers and market participants: the indirect economic, financial and social effects are massive, and no “quick fix” policy interventions are possible to solve the issue or mitigate its effects. With the share of people approaching retirement age increasing rapidly, electoral support for old age related reforms will be fading. Taking pro-active measures now will thus be essential.

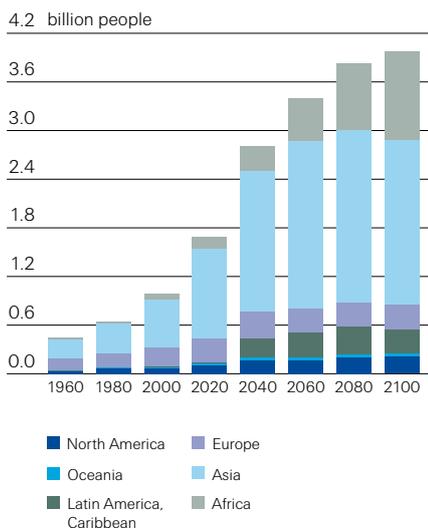
Broad implications

Ageing populations will first lead to an increase in age-related spending: pensions, healthcare, long-term care in old age and income support. As a direct consequence, countries with broad welfare systems (mostly developed markets) will suffer the most to pay for their contingent liabilities. Secondly, the ongoing transition from high to low birth rates will increase the dependency ratio, putting an extra burden

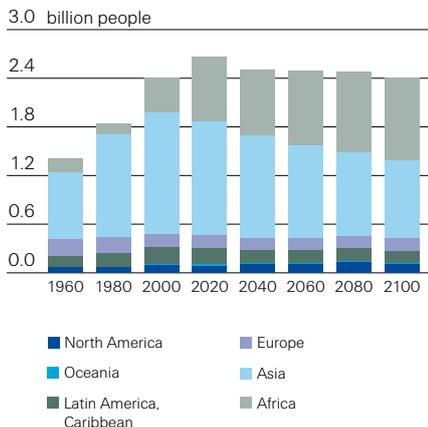
Long-term investor perspective

Longevity risk and rising contingent liabilities will be serious risks over the next decades. Given the long-term nature of the issues, awareness of possible market solutions (tools and instruments to transfer and manage longevity risk such as longevity swaps) has to be raised. Supporting and incentivising the private sector to save funds (third pillar savings) for retirement should also be encouraged.

UN world population: Age 50 and over



UN world population: Age 0–19



Source: UN Department of Economics and Social Affairs

¹ Refers to the period of economic benefits from falling child dependency and a rising working age population

Sources: “Ageing and asset prices”, Elod Takats, BIS Working Papers No. 318, August 2010; “Economic Growth and the Demographic Transition”, David E. Bloom et al, NBER Working Paper 8685, December 2001; “Population Challenges and Development Goals”, UN Population Division, 2005; Della Vigna S. and Pollet J. (2007). American Economic Review, December; Liu, Zheng and Spiegel, Mark M. (2011). FRBSF Economic Letter, Boomer Retirement: Headwinds for U.S. Equity Markets?; “Population Aging and the Effects on Asset Returns”, Vina Nguyen, PhD Seminar Paper, Brandeis University, October 2011; UBS Investment Research, Weekly Weight Watcher, Considering demographics, 27 April 2012; “Demographic Change and Asset Prices”, Robin Brooks, IMF, May 2005

EU financial transaction tax

Key messages

- It is highly doubtful that the purported benefits of an FTT can outweigh the associated costs, particularly in the current recessionary environment in Europe.
- The achievement of the stated goals through the introduction of an FTT remains questionable.
- Both economic theory and experience suggest that the ultimate burden of the tax is likely to be borne by the end users and not by financial institutions as intermediaries.
- The introduction of an FTT could not only significantly decrease liquidity in various market segments (and thus also lead to higher volatility) but also increase the costs of capital to firms.

Issue

In September 2011, the European Commission (EC) put forward a proposal for a Financial Transaction Tax (FTT) aimed at (i) "harmonizing legislation concerning indirect taxation on financial transactions", (ii) "ensuring that financial institutions make a fair and substantial contribution to covering the costs of the recent crisis", and (iii) "creating appropriate disincentives for transactions that do not enhance the efficiency of financial markets"¹. The proposal, which is estimated to generate about EUR 25–57 billion in annual revenues, foresees a tax rate of 0.1% for trading stocks and bonds and of 0.01% for derivative transactions.

Latest developments: On 12 December 2012, the European Parliament gave its consent for the eleven countries planning to introduce an FTT². Subject to approval by the Council and further rulemaking by the Commission, the FTT is expected to be implemented in early 2014. Some details, such as reporting obligations, payment mechanics and anti-abuse rules will be left for Member States to determine when implementing the directive.

Broad implications

The proposed FTT remains fiercely debated, with some countries, for example the UK and Sweden, opposing an FTT if it is not applied globally. The main points of contention around which the discussion has centred include the following: (i) Economic impact: The tax is expected to have a negative impact on GDP. The EC itself estimates the macroeconomic impact on European GDP to be a cumulative deviation of –0.53% to –1.76% in the long run. The Impact Assessment of the EC further suggests that firms' costs of capital may increase, which will have detrimental effects on economic growth and employment. (ii) Financial market impact: Market liquidity in some traded products is forecast to decline significantly. For example, the EC expects the turnover in some segments of the derivatives markets to decline by up to 90%. (iii) Scope: It is often argued that the introduction of an

FTT only at the European level makes the initiative ineffective and also puts financial institutions in Europe at a competitive disadvantage. Given the high mobility of capital, financial transactions are to some extent expected to shift to preferred tax jurisdictions. In addition, the FTT also aims to curb speculative and high frequency trading without a 'link' to the real economy. However, FX spot trading, for example, will be exempted from the current proposal. (iv) Tax incidence: The bulk of the tax will not be borne by the financial industry but be passed on to the end users – a potential outcome also acknowledged by the European Commission's own impact study. Thus, clients such as pension and mutual funds and their respective investors may end up bearing the ultimate economic burden – and not the financial institutions as intended. (v) Type of tax instrument: An FTT levied on financial transactions may not only cascade through the supply chain "in unpredictable ways"³, but it is also generally viewed as being less efficient in raising revenues than other type of taxes. For example, the IMF notes that "most countries have found the VAT – which effectively excludes transactions between businesses – to be a more efficient revenue-raiser than turnover taxes. In pure revenue raising terms, there are more efficient instruments than an FTT."⁴

Long-term investor perspective

A financial transaction tax as designed is inapplicable to fulfill the intended goals, ie – generating revenue for the public sector while fostering financial stability and curbing speculation. In fact, the points of contention mentioned above suggest that the implementation of an FTT will not only miss its goal but even be counterproductive and have a damaging impact in different ways, such as a negative impact on economic growth and employment, and significantly impair liquidity (and thus potentially lead to higher volatility) in various market segments. Along with the ultimate costs of the FTT all these effects finally will have to be borne by the end users, ie European citizens, private investors and pensioners.

¹ European Commission, Proposal for a Council Decision authorizing enhanced cooperation in the area of financial transaction tax, 25 October 2012

² The 11 member countries include Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia

³ IMF, Taxing Finance, Finance & Development, September 2012

⁴ IMF, June 2012, A Fair and Substantial Contribution by the Financial Sector, Final Report for the G-20

Public sector debt restructuring

Key messages

- In cases where debt dynamics are already unsustainable, sovereign debt restructuring based on a voluntary code of conduct such as the Principles for Stable Capital Flows and Fair Debt Restructuring can help restore market stability.
- The Principles provide an effective framework for reaching a voluntary agreement including transparent, good-faith negotiations between creditors and debtors, in close consultation with the official sector. The incorporation of collective action clauses can facilitate negotiations.
- The IMF has a vital role in sovereign debt restructuring, both in rigorous surveillance and in collaborating with private sector creditors.

Issue

In highly interlinked global financial markets, sovereign defaults are increasingly a source of systemic risk. Unlike corporate default, which is governed by domestic bankruptcy law in most jurisdictions, there is no legal framework for sovereign debt restructuring. However, the experiences of the last several decades suggest that most sovereign bond exchanges have been implemented quickly and without severe creditor coordination problems (creditor litigation in the context of bond restructuring has been rare, and “holdouts” have been relatively few). This highlights the importance of the Principles for Stable Capital Flows and Fair Debt Restructuring¹. The overriding strength of the Principles is that they incorporate voluntary, market-based, flexible guidelines for the behavior and actions of debtors and creditors. The main benefit for the system as a whole is their proactive and growth-oriented focus, given that the Principles are operative not only after a crisis has occurred, but also during times of diminished market access and the early stages of crisis containment. Going forward, market practices need to evolve over the implementation of collective action clauses (CACs) to facilitate an orderly and effective sovereign debt restructuring, one which respects creditor rights, contributes to crisis resolution, minimises litigation and allows the sovereign debtor to swiftly regain access to international capital markets.

Broad implications

In the wake of the Latin American and Asian sovereign debt crises in the 1980s and 1990s, and more recently the voluntary Greek debt restructuring, international debate on this topic has gathered steam. However, efforts to introduce centralised, top-down mechanisms for sovereign debt restructuring have proved unworkable. Should debt restructuring prove necessary, the application of the Principles in terms of good-faith negotiations between a representative creditor committee and the sovereign debtor – in close consultation with the official sector – have proved to be the most effective framework for reaching a voluntary agreement. Agreement on a broad multi-year macroeconomic framework and objectives – with provision for fair burden sharing – can

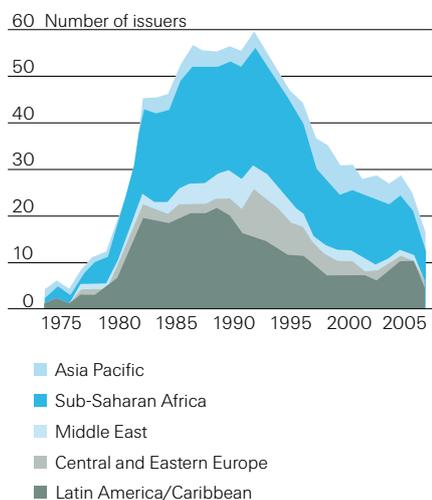
promote high private creditor participation, restoration of market access and renewed output growth. The adoption of investor relations programmes and incorporation of collective action clauses can facilitate negotiations and creditor participation; it is worth noting that in the context of the European Stability Mechanism, all new Euro Area government bonds will include CACs starting in 2013.

Development of a framework for sovereign debt restructuring has been greatly advanced by the establishment of the Principles² welcomed and supported by the G20 Finance Ministers and Central Bank Governors in Berlin in 2004. The implementation of the Principles is overseen by the Group of Trustees, consisting of 44 current and former leaders in global finance with exceptional experience and credibility. The flexible guidelines for cooperation and engagement offered by the Principles have been accepted as the preferred framework for sovereign debt restructuring, also for the voluntary Greek debt exchange.

Long-term investor perspective

To help avoid costly sovereign bailouts, investors and other private creditors have a major role to play. Due diligence and sound risk management practices are a key part of crisis prevention, as is support for the voluntary code of conduct set out by the Principles. Investor willingness to participate in timely, good-faith negotiations if debt resolution becomes necessary is vital – delay in reaching voluntary agreement on restructuring aggravates the adverse impact on investor balance sheets, making it more difficult for sovereign debtors to regain market access. It is also important to note that in any sovereign debt restructuring, the role of the IMF – rigorous pursuit of economic surveillance coupled with provision of timely and objective analysis on the debtor’s macroeconomic prospects and medium-term funding needs – is vital. As an essential component of the restructuring process, the IMF should view private sector creditors (e.g. via a creditor committee) as partners in key areas such as determination of debt sustainability and negotiating a fair burden sharing arrangement.

Sovereign defaults over time



Sources: Hatchondo, Martinez & Sapriz, Federal Reserve bank of Richmond Economic Quarterly, Spring 2007

¹ For example, see Das, Udaibir S. / Papaioannou, Michael G. / Trebesch, Christoph, Sovereign Debt Restructurings 1950-2010: Literature Survey, Data, and Stylized Facts, IMF Working Paper (WP/12/203), p. 96.

² Principles for Stable Capital Flows and Fair Debt Restructuring (see <http://www.iif.com/emp/principles/>).

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Title:

Strengthening the role of long-term investors
The crucial role of long-term investor is at risk – Eight
fact sheets on issues and challenges

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