ESMA Survey on collection of evidence on undue short-term pressure from the financial sector on corporations
Draft AAE Response
Malcolm Kemp – 21 July 2019

1. Name of the company / organisation

Actuarial Association of Europe

2. Type of respondent

Other

The Actuarial Association of Europe (AAE) was established in 1978 under the name Groupe Consultatif to represent actuarial associations in Europe. Its purpose is to provide advice and opinions to the various organisations of the European Union – the Commission, the Council of Ministers, the European Parliament, EIOPA and their various committees – on actuarial issues in European legislation. The AAE currently has 36 member associations in 35 European countries, representing over 24,000 actuaries. Advice and comments provided by the AAE on behalf of the European actuarial profession are totally independent of industry interests.

3. Industry

Not industry specific. Actuaries advise a range of organisations including insurers, pension funds and corporates sponsoring pension funds. These corporates can be found across a wide range of industry sectors.

4. Are you representing an association?

Yes

5. Country

All mentioned

6. Please indicate if wish to have your response published on the ESMA website

Yes

7. This questionnaire considers long-term investment in the framework of sustainable finance, under the assumption that long-term investment projects should be consistent with the objective of supporting the shift towards a more sustainable financial and economic system. In this context, for the purpose of filling in this questionnaire, what timeframe would you consider when defining long-term investment?

Other: Yes

Investors and other organisations advised by actuaries have a wide range of investment horizons. For example, insurers writing short-tail insurance such as motor insurance may have investment horizons at the short end of the ones listed. Conversely, pension funds and other long-term investors that actuaries may advise may have a material fraction of their liabilities that are more than 30 years into the future.

All these investors contribute to the broader accumulation of capital that can be used by society for a variety of purposes, including transition to a more sustainable economy and a low carbon economy.

8. Which time horizon do you apply in your general business activities?

-

9. In your experience, to which extent do the following nodes in the investment value chain contribute to the tendency towards short-termism?

The definition of 'short-termism' given in the Survey Introduction is "the focus on short time horizons by both corporate managers and financial markets, prioritising near-term shareholder interests over long-term growth of the firm".

Some such short-termism clearly exists. Some corporations target business activities that they know are likely to be profitable but have only a relatively short shelf-life, e.g. because of likely product or business obsolescence. These corporations may rationally decide to return these profits to shareholders rather than invest to grow their business if they see no clear longer-term business activities that they think they have competitive advantages to undertake. This is 'short-term' according to the above definition but may still foster socially desirable economic growth if the shareholders reinvest the proceeds returned to them in a relevant manner.

Conversely, there are many corporates, particularly in sectors of the market being disrupted by new technologies, that have business strategies focusing strongly on longer-term growth at the expense of short-term profitability. These do not involve 'short-termism' as defined above. However, they will not necessarily achieve the longer-term societal aims also referred to in this survey if, for example, the longer-term goals being pursued by such firms are at variance with these aims or if the growth strategy being pursued is poorly envisioned or poorly executed.

Instead of focusing exclusively on the definition of 'short-termism' given above, we think it would be better to focus on the overall end-result, accepting that different participants in the value chain have different objectives and hence can be expected to give greater or lesser emphasis to long-term societal goals. In our view, almost every player in the financial system will to some extent be trading off 'short-termism' versus 'long-termism', i.e. all parts potentially contribute to any perceived tendency towards short-termism, including end clients and even the public sector, regulators and politicians. For example:

(a) Investors typically prefer the ability to alter how their capital is invested, if only to protect themselves against unexpected future events such as political change. Therefore, they are more likely to invest in longer-term investment opportunities if there is greater likelihood of them being able to sell their investment to another investor in the meantime. A recognition of the importance of this driver of investor behaviour underpins the EU's capital markets strategy. However, this investor preference also naturally introduces a degree of short-termism, since markets are only able to support this preference by facilitating short-term reallocation of investment if investors so wish.

(b) Many institutional investors look after money on behalf of others. Their investment strategies therefore need to take account of the nature of their liabilities to customers, policyholders or beneficiaries. If their end clients can demand or expect to receive back their investments in the short term, this necessarily also introduces a need for some level of 'short-termism' on the part of the institutional investor. The added regulatory emphasis placed on liquidity management in recent years is an outworking of this investor requirement.

(c) Some activities that can be expected to support, say, the transition to a low carbon economy involve public goods. The level of reward available to the private sector from carrying out basic research that might eventually lead to say more efficient batteries or solar cells may be inadequate. This type of research may therefore need pump-priming via public sector funding, but this funding may itself be in short supply. Some types of broader societal 'capital' we might expect to facilitate longer-term investment, such as the continued existence of a fair legal system, also require public support.

(d) Suppose that somehow a ban on short-termism was introduced in some area. This would likely limit the liquidity of investments in that area. This would then likely make investors require a liquidity premium, thus making long-term financing of projects more expensive

(e) Some statistics appear to support the notion that finance has become more short-termist in recent years, e.g. frequency of trades. These statistics in part reflect an increasing amount of high-frequency trading (HFT) taking place in recent years. However, it is hard to draw any meaningful conclusion from the rise in HFT about trends in ease or difficulty in accessing long-term finance. HFT may merely be substituting for trading that had still been relatively short-term, just not as rapid as is now more practical using automated HFT algorithms.

If the end-result of everyone's balancing between a 'short-term' and a 'long-term' focus gives insufficient weight to a targeted societal goal (e.g. a desired transition to a knowledge-based low carbon economy), then the best approach is likely to be to alter incentives in a manner that cascades across all participants, so that everyone makes some contribution to the goal. Such an approach is likely to best achieve the targeted outcome(s) being sought whilst still benefiting from other socially desirable characteristics of markets (more efficient allocation of capital etc.) that are less specific to the short-term versus long-term dimension.

10. To which extent does each of the following factors result in short-termism by your institution?

-

11. What is the actual holding period prevailing in your investment strategy?

-

12. To which extent does each of the following factors drive the actual holding period prevailing in your investment strategy?

The actual holding period adopted by many institutions advised by actuaries is to a substantial extent driven by non-prudential (e.g. conduct) and prudential regulation, given the importance such institutions need to place on treating customers fairly, on the prudent person principle and on the need for the assets to be selected in a manner that reflects the nature of the liabilities to which these assets relate. However, this will not necessarily create short-termism per se; it might instead encourage long-term investment strategies, if these reflect best the nature of the liabilities in question.

13. On a best-effort basis, in the next 2 years, how do you expect the average holding period of the following portfolios to evolve?

-

14. To which extent will the expected evolution in the average holding period, indicated under question 13, be driven by each of the following factors?

-

15. Based on your experience, please indicate to which extent you agree with the following statement: "Disclosure of ESG information by listed companies enables investors to take long-term investment decisions".

3: Partially disagree and partially agree

Disclosure of ESG information should assist investors. However, it is not the only contributor to long-term investment decisions, see answer to Q9

16. Assuming that investors are willing to consider ESG disclosure in their decision-making process, why does disclosure of ESG information by listed companies not enable investors to take long-term investment decisions?

Other

ESG is not the only contributor to investment decisions, so disclosure of ESG information alone may not always incentivise investors to target socially desired long-term investment strategies, see answer to Q9.

17. Why does disclosure of ESG information by listed companies enable long-term investment?

ESG disclosure provides insights into a listed company's long-term risk profile: Yes
ESG disclosure provides insights into a listed company's future financial performance: Yes
ESG disclosure complements the information provided by listed companies in their financial statements: Yes

See answers to Q15 and Q16

18. Even though you acknowledge that disclosure of ESG information by listed companies could enable long-term investment, you might have observed impediments as to how this link may work in practice. To which extent each of the following factors may discourage investors from using ESG disclosure to apply a long-term investment horizon?

-

19. In your view, would requiring specific disclosures on intangible assets which are not accounted for in the financial statements enable long-term investment decisions?

No

Disclosure of information on some intangible assets may assist investors. However, it would be important to ensure that these disclosures do not paint a firm in an artificially favourable light, thereby potentially misleading investors and other stakeholders.

20. The NFRD gives companies flexibility to disclose non-financial information to the extent necessary for an understanding of the undertaking's development, performance, position and the impact of its activity in relation to non-financial matters. Do you consider that further requirements are needed to increase the level of detail in the disclosure requirements regarding non-financial information?

-

21. Do you consider that further steps in the area of non-financial reporting are needed at the national or the European level to enable investors to take long-term investment decisions?

-

22. Based on your experience, please indicate to which extent you agree with the following statement: “For the purpose of undertaking an internal assessment of the performance of long-term investments held in equity instruments, fair value provides a company’s management with relevant information in order to better understand the short-term and the long-term consequences of the investments held”

4: Mostly agree

Fair value provides a comparison that can assist management in deciding on the relative merits of different business strategies and different ways of investing any available capital.

23. Based on your experience, please indicate to which extent you agree with the following statement: “For the purpose of enabling an external analyst or investor to assess the performance of long-term investments held in equity instruments by a company, fair value provides relevant information in order to better understand the short-term and the long-term consequences of the investments”

4: Mostly agree

See answer to Q22. In addition, many (institutional) investors operate unitised vehicles. It is hard to apportion value ‘fairly’ between participants in such vehicles if the effective price at which transactions between participants is struck at anything other than a ‘fair’ value, where ‘fair’ here is taken to mean the price that would be ascribed to the client’s unit holdings by the market.

24. Is the current accounting treatment for equity instruments under IFRS 9 a decisive factor in discouraging a company from undertaking new long-term investments in equities?

No

Most investors subject to IFRS 9 and advised by actuaries will use fair value for equity investment under IFRS 9 and in most cases this is likely to be an appropriate treatment, if the equity is relatively liquid and not likely to be held to maturity by the investor.

25. Is the current accounting treatment for equity instruments under IFRS 9 a decisive factor in triggering divestment by a company of existing equity holdings elected for the long-term?

-

26. In your view, what are the factors that may impact the relevance to users of financial statements of fair value measurements for long-term investments?

Other

Most equities held by investors that actuaries advise are likely to be publicly listed equities and will be fair valued without too much difficulty.

27. Is your investment strategy predominantly active or passive?

-

28. Please elaborate on how the actual holding period of your investments (as you have indicated under question 11) matches with your investment mandate

-

29. To which extent does your firm integrate long-term value considerations for the purpose of setting its investment strategy (and subsequent portfolio allocation choices)?

-

30. To which extent does your firm integrate long-term value considerations for the purpose of setting its engagement policy (and subsequent engagement activities)?

-

31. How does your firm engage with the investee companies in order to mitigate any potential sources of undue short-termism?

-

32. What are the main topics your firm engages on in order to mitigate any potential sources of undue short-termism?

-

33. To which extent does your firm rely on proxy advisors for the purpose of deciding how to vote in order to mitigate any potential sources of undue short-termism?

-

34. Please indicate your agreement with the following statement: "Proxy advisors take into consideration long-term value when they provide voting advice"

4: Mostly agree

In our experience most proxy advisors take into account a wide range of factors when providing voting advice, including likely impact of vote on long-term value.

35. Please indicate your agreement with the following statement: "Engagement activities can be an efficient way of mitigating any potential sources of undue short -termism"

-

36. To which extent do you consider your engagement activities successful in mitigating any potential sources of undue short-termism?

-

37. Which are the main obstacles that institutional investors face when engaging with investee companies, and how could they be addressed in your view?

-

38. Please indicate your agreement with the following statement: "The recent entry into application of the revised Shareholder Rights Directive is going to increase the extent to which your firm takes into account long-term value considerations for the purpose of setting your investment strategy and engagement policy"

-

39. What is the average investment horizon of the funds managed by your firm?

-

40. In the salaries of identified staff of your firm's funds, what is the average share of the variable component compared to the fixed component?

-

41. Over what average time is the reference period for variable remuneration calculated for the identified staff of your firm's funds?

-

42. What average percentage of variable remuneration do you defer for identified staff of your firm's funds?

-

43. On average, over what period do you defer the payment of the variable remuneration for identified staff of your firm's funds?

-

44. Do you believe there are common practices in the remuneration of fund managers that contribute to short-termism?

-

45. In your firm, what is the average share of the variable component of executive remuneration compared to the fixed component?

-

46. Over what average time is the reference period calculated for variable remuneration of your firm's executives?

-

47. Over what average period is the payment of the variable remuneration of your firm's executives deferred?

-

48. Is the awarding of variable remuneration to your firm's executives linked to any ESG-related objectives?

-

49. Do you believe there are common practices in the remuneration of corporate executives that contribute to short-termism?

-

50. What percentage of your funds are exposed to CDS?

0

51. If your funds are exposed to CDS, what are they primarily exposed to?

-

52. What kinds of CDS exposures do your funds hold?

-

53. If any of your funds hold sell only or net sell CDS positions, what is their primary investment strategy?

-

54. What is the average size of your fund's holding of sell only or net sell CDS exposures, expressed in assets under management (AUM)?

-

55. If you hold sell only or net sell CDS positions in any of your funds, please select in the list below one or several reasons for holding sell only or net sell CDS positions

-

56. If you hold sell only or net sell CDS positions in any of your funds, do you:

-

57. Are there other classes of derivatives used by investment funds that could increase short-termism in the economy?

-

58. Do you have any additional input you wish to provide in relation to the topics covered in this survey?

-

59. Do you consider that any topics beyond those covered in the survey should be addressed in ESMA’s advice to the European Commission on potential undue short-term pressures exercised by the financial sector on companies? Please provide links to any relevant material / publications.

-