National Conference on long-term financing

17 November 2011

Report

Delivered by Gérard de La Martinière,
Inspector-General of Finance

Summary

Foreword

Gérard de la Martinière's report is one of the most informative documents about our country's financing, but also one of the most concerning.

We face a highly paradoxical situation. On the one hand, long-term financing needs are significant and growing in view of the environmental and demographic constraints seen. On the other hand, long-term financing is being discouraged by the public authorities. What lies behind this paradox? In reality, the financial crisis we are experiencing has been fuelled and preceded by a whole series of structural deviations which regulators have sought to immunise financial institutions against, even if this means undermining long-term financing.

What are these deviations? The first concerns the main macroeconomic structural deficits. A lack of exchange rate discipline has been reflected in maximum tolerance to the growth and the persistence of structural deficits of the balances of payments. The international abundance of liquidity, which stemmed from these imbalances and the systematic intervention by central banks from structurally creditor countries, has facilitated access to financing across the entire economy for years. A lax monetary policy, characterised by real interest rates of almost zero for close to a decade, has encouraged the use of leverage among financial institutions and the creation of both credit and asset bubbles.

The combination of these developments, compounded by the pro cyclical fair-value accounting methods, has caused one of the biggest financial crises in history.

Unfortunately, as is often the case, the public authorities'responses have not always looked at the underlying factors behind the crisis.

No significant progress has been achieved with the multilateral surveillance of economic imbalances caused by macroeconomic policies, or in terms of bringing the current balance of payment deficits effectively under control.

As far as the monetary policy is concerned, it is taking a long time to focus on the real issue that led to the crisis: i. e. excessive credit growth. The issues linked to credit bubbles or excesses can only be tackled with the effective and considered use of financial regulation instruments by newly created systemic risk boards.

Alongside this, financial institutions have tended to be further strengthened – which was highly desirable – but this has been done by focusing, in my opinion, too exclusively on raising their capital levels.

Their capital levels needed to be raised in order to make them more resilient and enable them to cope with more losses. But everything is a matter of moderation: there is a point beyond which further strengthening their capital can have unexpected and unintended consequences. This is the case with the Basel 3 rules, multiplying the capital levels for banks by around five, and even 10 for the biggest financial players.

Ultimately, the tendency among regulators would put an end to the leverage effect for banks since the capital would, according to them, need to cover all the losses that could occur, even if they are caused by events outside of the banks. In the current climate with a stock market that is very depressed, offering relatively limited possibilities for raising fresh capital, the regulatory tendency has led banks to scale down their balance sheets.

This may appear to be a good idea considering what has been outlined above in terms of excessive leverage. Nevertheless, a certain number of banks, may be tempted not to cut back on their riskiest lending practices, but rather on their least lucrative lending (to SMEs for instance) or credit facilities denominated in currencies whose liquidity is tightening up.

If we also factor in the new constraints in terms of liquidity, there is a significant risk that the reduction in leverage will reach significant proportions, highly penalising for the financing of our economies, especially in Europe, where bank intermediation plays a decisive role. Asking the banks to align the maturities for their financing with the maturities for their debts can only be achieved without causing too much damage if the long-term resources offered to the banks are available and at reasonable rates. However, the circumstances seen for the past few years have not been encouraging this type of long-term financing.

The upshot will be a need to reduce the duration of assets, contributing towards penalising the economy's long term financing.

As far as insurance companies are concerned, once again I can only fully agree with Mr. de la Martinière's excellent rapport. As long as we consider that an organisation's solvency should be assessed based on being liquidated after one year, we face two risks.

The first is the risk of aligning these companies with a short-term timeframe that is not consistent with the horizon for their actual business (which represents the most serious mistake in regulations). The second risk is preventing these companies from holding long assets, particularly as equities, since these do not fit into the framework for short-term liquidation. Under these conditions, one of the vital driving forces for equity financing and long financing for the economy will tend to run out of steam. And yet, the deviations seen during the financial crisis have been caused by a lack of equity.

In the end, rather than continuing to raise capital levels, it would be better for regulations to focus on controlling the quality of the risks taken by financial institutions. Naturally, this is the most difficult task facing supervisors, who cannot rely entirely on the mathematical internal models, whose shortcomings have been revealed. However, this area has still been largely overlooked. Even the weighting of risks under Basel 3 still varies considerably depending on the country and even the institution.

From my perspective, addressing this admittedly difficult initiative at European and international level represents a more important objective than systematically raising capital levels.

Jacques de Larosière

Chairman of Eurofi

Executive summary

The report issued on the "National Conference on Long Term Financing" delivered a diagnosis concerning the long-term investment needs of the French economy, identified the structural obstacles created by the new regimes applicable to savings and financial activities, and made proposals to reconstitute long-term investment capacity.

The first part of the report notes that massive needs of long-term financing are justified both economically and in the public interest, particularly with regard to projects of renewal and adaptation of infrastructure.

Yet, despite the importance of these needs, the financing infrastructure remains inadequate in a context of tight budgets, thereby endangering the transition to a low carbon economy.

In these circumstances, the critical issue is the mobilization of domestic savings. Experiencing international competition to attract capital flows, France must redirect plentiful savings insufficiently focused on long-term by seizing the opportunity to longevity which is decisive in terms of financing long-term needs.

Demographic lever must be used because the banking sector sees its role of intermediation and transformation evolving, given the impact of new prudential standards.

Therefore, in a context where market funding of French companies is not optimal and where, furthermore, the restoration of securitization may be considered only under strict conditions, the contribution of long term investors could be crucial if a regulatory framework adapted to their business model is set up.

The second part of the report observes that the accounting and prudential regulations do not take into account the specificities of these investors and that current developments are detrimental to long-term financing of the economy:
– market value accounting results in the income statements and balance sheets of financial institutions being more sensitive to short-term fluctuations in the markets;
– prudential approaches are constructed by reference to a view of no more than one year, reinforcing investors' propensity to shorten their investment horizons;
– by over calibrating the equity risk and penalizing long durations, the Solvency II approach shows its flaws that ultimately penalizes essential investment segments.

Finally, a third party of the report examines the taxation of long-term investment.

Questioning the overall context of the savings taxation regime, the report shows that the products of savings and capital can not be seen as benefiting from a more favourable treatment than labour income.

In addition, the report underlines the ongoing legislative instability, which is inconsistent with a long-term savings that needs stability.

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Here are summarized the key ideas from this French market brainstorming, whose mission is to take a European dimension to implement a more conducive environment for long-term investment in Europe, and thus, to contribute to growth and competitiveness in European Union.

9 key – recommendations

- Reassert the necessity for a financial institution to assess the risks of assets taking into account the nature and the duration of the liabilities.
- Design a model of assessment of financial risks that recognises the positive effect of long-term liabilities.
- Promote the creation of long-term savings by developing suitable investment instruments.

For households

- To encourage low-income individuals to bolster their mid or long-term savings.
- To introduce in French law a "taxation standstill": that means to give a certain volume of savings a guarantee of tax and social security stability. This volume could be allocated to several savings products or media within one contractual commitment.

For SME's

- Develop the reduction mechanisms related to Wealth Tax and Income tax regimes for SME's investments by enhancing the scope of intermediation.
- Provide a system of fiscal transparency to shareholders of companies recently established to absorb, especially in the family circle, the inevitable losses of the company's starting.

For businesses

- Widespread tax deduction on dividends outside the "parent-subsidiary" regime.
- For financial sector companies: to admit the deductibility of equalization reserves, as they should be calibrated by the prudential and accounting regulation.

General Introduction

In order to get back on the road to firm and sustainable growth, Europe must embark upon a massive programme of investment, both quantitatively and qualitatively.

The needs are particularly large in the areas of infrastructure, business and local authority financing, research and innovation and sustainable development. There is a danger that these needs will not now be satisfied.

In fact, public budgets, which in the past had made a major contribution, in particular to infrastructure financing, are now seriously constrained and will remain so for several years. The background of economic uncertainty and financial crisis, combined with the effect of new regulations, has given rise to a growing aversion to risk-taking. The latest observations are worrying: the risk of a credit squeeze, sharply-reduced investment capital fund-raising in 2011, a net slowdown in direct foreign investments, etc. These are all factors that could compromise the financing of the economy and a return to growth through investment.

In order to meet this challenge, the *Caisse des Dépôts* has taken the initiative of launching a major national study by all those involved in the French economy and concerned about the long term – banks, insurance companies, businesses, trade federations, etc. – at a National Conference on Long-Term Financing to be held in Paris on 17 November of this year.

Under the direction of Mr Gérard de la Martinière, former Chairman of the FFSA, we have arrived at a diagnosis concerning the long-term investment needs of the French economy, identified the structural obstacles created by the new regimes applicable to savings and financial activities, and made proposals to reconstitute long-term investment capacity.

Our work has highlighted the risk of a major discrepancy between the need for medium to long-term investment and the likely capacity of a financial sector under increased liquidity constraints to provide the necessary capital over the long term.

In our view, the gradual reduction of the structural discrepancy between long-term financing supply and demand requires:
– a concentration of public expenditure on future investments of most relevance to competitiveness and growth;
– adaptation of the prudential and accounting framework to the specific characteristics of long-term investment in order to enable the anticipated supply of capital to be redeployed to those jobs. New regulations should evolve so as to be better adapted to the various economic models of financial institutions and so as to take account of the nature and duration of their liabilities;
– a fiscal framework that encourages household savings to be directed towards long-term financial products intended, in particular, to cover the risk of longevity, in the context of an overriding requirement for stability.

We hope that this collective study of the French market will mark the start of a dynamic process that will take on a European dimension and acquire a critical mass capable of shifting the emphasis of the content of regulations damaging to investment and of changing the worrying tendency towards a generalised short-termism.

Long-term investment

The long-term investment needs of the French economy

Rapporteur : Didier Janci,
Chief economist, Caisse des Dépôts

The growth potential of Europe and in particular of France is being undermined by a lack of long-term investment. There are particularly large unsatisfied needs as regards the financing of innovative businesses, infrastructures and the transition towards an economy that is more respectful of mankind and the environment.

Against a background of structurally degraded public finances, the gradual reduction of the discrepancy between financing supply and demand of long term financing calls for the organisation of project choices and public resources allocation, which could take place in accordance with the following criteria :
– identification and selection of the most relevant future investments to provide competitiveness and growth in the medium and long run, based on a cost-benefit analysis that, in particular, assess the externalities of such investments;
– concentration of public expenditure on investments that are priorities for the future, not only in France but also at European level;
– implementation of public-private partnerships that guarantee a fair distribution of yields and risks between the public and private parties.

It also appears crucial to mobilise domestic savings in favour of long term financing by making adjustments to regulations and tax. In addition to developing existing schemes, the introduction of new financing vehicles enabling household savings, and particularly those intended for retirement, to be channelled towards these future investments might be explored. Care should be taken to ensure that such new financial products are well designed in terms of assets and liabilities management. From this point of view, the infrastructure asset class has interesting characteristics.

The financial institutions that manage a substantial proportion of households' investments must be able to play their intermediation and transformation role for the financing of the real economy. Currently, however (and this will be all the more the case in the future due to future prudential regulations), those involved in finance (banks, insurance companies and institutional investors) and the capital markets do not provide sufficient financing for such long-term and/or risky investments, in the form of equity capital and debt.

In this context, long-term investors have a decisive role to play in taking on three additional functions:
– the financing of these long-term and risky investments;
– the supervision of the businesses in which they invest; and
– the stabilisation of the markets.

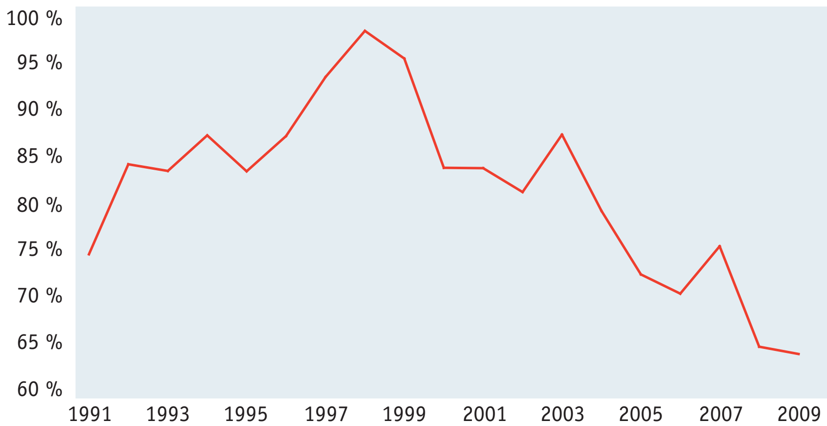
In doing so they will contribute to the diversity of the world of finance, to its greater efficiency, and to its strength through a better distribution of risk. But, in order to be able to play their part correctly, long-term investors need a suitable regulatory framework that does not penalise long-term and risky investments. It is essential for their financial model to be recognised, particularly from an accounting point of view (*cf.* “Financial sector” key recommendations).

Long-term financing needs that are economically and socially justified

The financing of businesses: the low level of business investment, in particular by SMEs, is undermining the competitiveness of french economy in the medium term

The rate of self-financing by businesses has declined very markedly in the last 10 years (cf. the chart below) while at the same time the proportion of distributed profits has increased considerably.

Self-financing rate of non-financial French companies



Source: National accounts – 2000 base, Insee.

This situation is not damaging in itself if the businesses can offset the lack of funds placed in reserve by means of external financing provided by way of debt or equity capital contributions. From this point of view, the finding that French businesses currently have a level of equity capital that is globally regarded as satisfactory on an aggregated basis (*cf.* the report of the *Observatoire du Financement des PME 2010*) must be qualified. First, the level of current investment by French businesses is very low (*cf.* below), and secondly, this aggregate finding could conceal major disparities. In particular, businesses regarded as more risky, and especially young innovative businesses and SMEs or intermediate-sized companies that are growing rapidly or that are going through a transition phase, do not always have access to such financing in satisfactory terms. These businesses could find themselves constrained in terms of financing, and particularly in terms of bank financing.

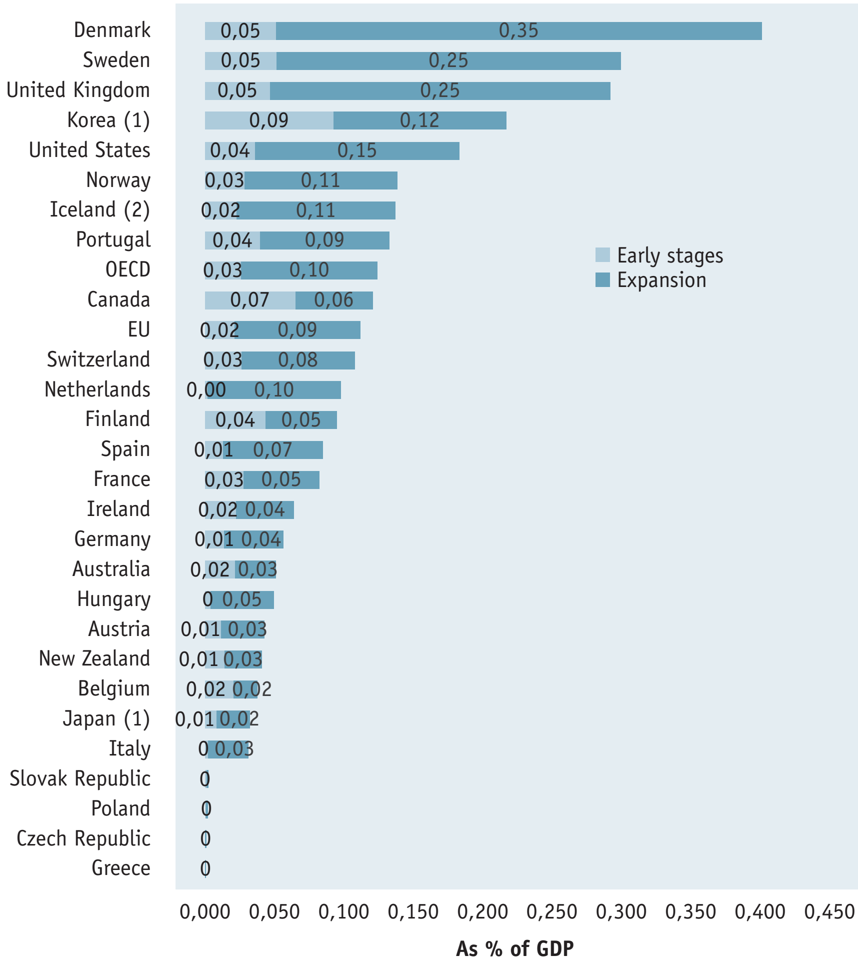
Furthermore, while the above finding is universal in nature, the growth of private equity in France[1], and in particular of venture capital, is still inadequate, and is a specific risk factor that penalises these businesses :

1 The French private equity market has expanded considerably since 2000 and was the second-largest European market in 2008 behind the United Kingdom, with annual growth of between 10 % and 20 % during this decade (cf. the report of the *Observatoire du Financement des PME 2010*).

- In 2007, the ratio of early stages capital to GDP in France was 0.028 % (compared to an average of 0.021 % in OECD countries), a level significantly lower than those in the United Kingdom (0.047 % of GDP), the United States (0.036 % of GDP) or in the Nordic countries; these markets are more mature than the French market and their ratios could constitute a reasonable target for the French market.

- The ratio of expansion capital to GDP was 0.055 % (compared to an average of 0.098 % in OECD countries), a level well below those in the United Kingdom (0.245 % of GDP), the United States (0.147 % of GDP) or the Nordic countries.

Venture Capital investment as a % of GDP in 2007



Source: OCDE-OECD Science, Technology and Industry Scoreboard 2009.

According to the French Private Equity Association (Association Française des Investisseurs en Capital), flows of private equity received by French businesses virtually returned to their pre-crisis level in the first half of 2011. On the other hand private fund-raising has declined markedly since 2008 (cf. the table below) and has not recovered (it declined again, by 6 %, in the first half of 2011), in a context marked by the disengagement of institutional investors penalised by amendments to the regulatory frameworks (Basel III and Solvency II). Considering these developments, a lack of resources can be anticipated in the fairly near future, mainly as regards the upstream part of venture capital, which specifically finances small businesses in the process of being created and innovative businesses: the

AFIC's statistics show that for the last two years, French private equity funds investment flows have been larger than the one being raised.

Private equity trends (in millions of euros)

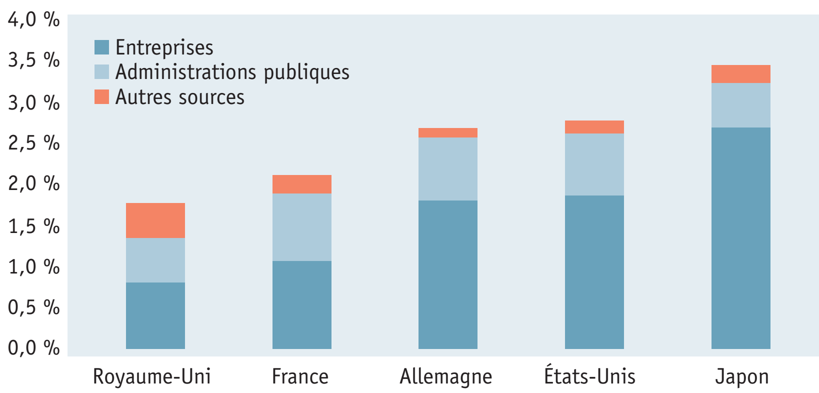
	2005	2006	2007	2008	2009	2010	Variation 2009 / 2010	TCAM* 2005 / 2010
Fonds levés	**11 954**	**10 280**	**9 995**	**12 730**	**3 672**	**5 043**	**37%**	**-16%**
Investissements	**8 072**	**10 164**	**12 554**	**10 009**	**4 100**	**6 598**	**61%**	**-4%**
dont capital risque	481	536	677	758	587	605	3%	5%
dont capital développement	895	1 057	1 310	1 653	1 798	2 310	28%	21%
dont capital transmission / LBO	6 287	8 075	10 340	7 399	1 605	3 512	119%	-11%
dont capital retournement	59	95	84	99	84	90	7%	9%
dont autres	349	401	143	100	26	80	208%	-26%
Désinvestissements	**4 253**	**3 796**	**5 660**	**3 164**	**2 782**	**3 987**	**43%**	**-1%**

Source : Afic – Activité des acteurs français du Capital Investissement en 2010

* Taux de Croissance Annuel Moyen

These factors are hampering France's innovation potential, upon which its future growth depends. In particular, even though current mechanisms, and especially the Research Tax Credit, are having a substantially positive effect, the level of private research and development (R&D) in France remains low compared to other countries (*cf.* the chart below).

Domestic R&D expenditure by source of financing as proportion of total domestic R&D expenditure, in 2008



Source: Eurostat.

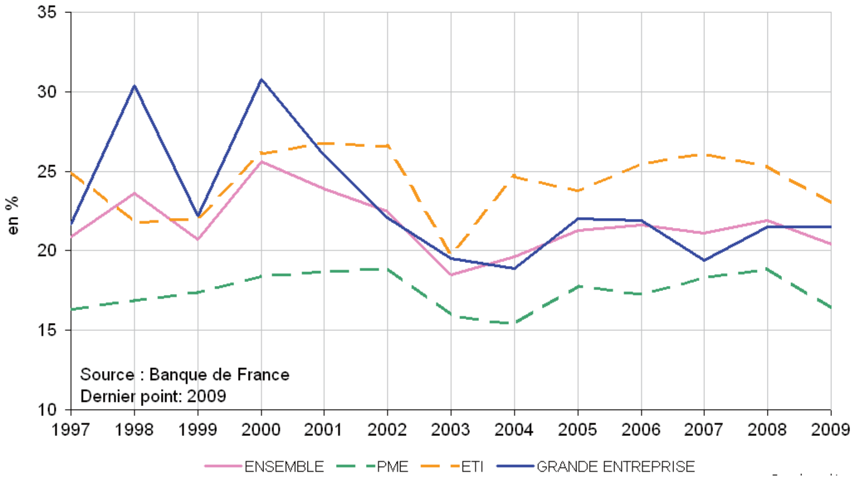
Moreover, these factors can also partially explain:

– why, structurally, French SMEs invest relatively little compared to businesses of a larger size (*cf.* the chart below);

– the relatively low number of medium-sized companies in France, which has fallen from 4,600 in 2007 to 4,200 in 2009, according to *Banque de France*;

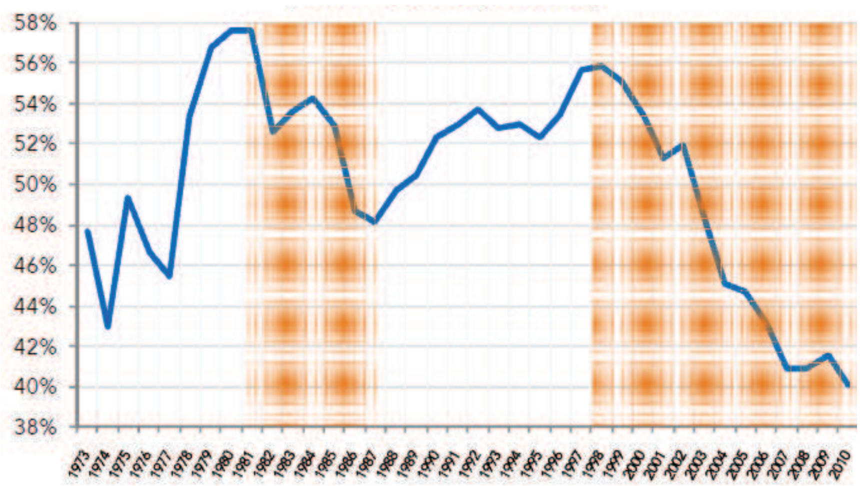
– some structural competitiveness problems of the French economy.

Rate of investment (investment/added value) by size of companies



Source: *Banque de France*, last data 2009.

French exports/German exports Ratio



Source: Eurostat and CHELEM, CEPII.

These phenomena could be accentuated by the crisis: in a scarcely growing and very volatile environment, the anticipated profitability of their investment projects appears to be inadequate or too uncertain for businesses that value their security (with a high level of liquidity) to the detriment of investments bringing down growth in the medium term.

Finally, it is worth mentioning a sovereignty issue: the substantial level of ownership of the capital of so-called "French champions" by non-residents (40 % to 45 %). This figure does not leave much room for manoeuvre to prevent reaching the tipping point where these companies will decouple from their roots and from their environment. At the same time, it introduces a vulnerability factor due to reduced stability. The same analysis could probably be transposed to European level.

Financing of infrastructures: in the next few decades there will be a very substantial need both in terms of new projects and also the renewal and adaptation of existing infrastructures

Economic infrastructures as that term is used by the OECD (infrastructures for the transportation of people, goods, energy and information) constitute the backbone of a country's economy and are, in the same way as innovation, one of the pillars of its competitiveness and long-term growth. They are also of major structural importance for society because they have, in most cases, positive socio-economic and environmental externalities. This will particularly be the case in the next few decades in a context of transition towards an economy that is more environmentally-friendly and that takes account of new requirements in terms of energy efficiency and the prevention of pollution and greenhouse gas emissions. The stakes are very high both for the development of new infrastructures (offshore wind farms, deployment of ultra high-speed internet, Greater Paris, etc.) and for the renewal and adaptation of those already in existence (airports, energy transfer and distribution networks, buildings, etc.).

Financing needs

At European level, the Commission estimates a requirement of more than €1,600 billion between now and 2020 for trans-borders infrastructures to transport goods, people and energy.

In France, major developments are also expected:

• *Energy*: the need for investment in this area will continue to grow, a development mainly driven by the electricity production sector. In this area, the main challenges will be to renew ageing nuclear installations (3/4 of power stations will reach the end of their lives in 2020) and to give a larger share of production to renewable energies and gas in an effort to limit carbon dioxide emissions. By 2015, these investments should amount to about €11 billion per year, with the electricity sector being largely predominant. During the period 2016-2020, a significant increase in investments in electricity production will be necessary; the total amount of such investments should thus be between €16 billion and €17 billion per year, of which more than half will be devoted to electricity production. After 2020, the situation will be more uncertain; in any event, the role given to the nuclear industry will be a key challenge. Arbitrages between EPRs, the construction of combined cycle gas power stations, and renewable energies (water and wind power, etc.), will probably have to be made.

• *Transport*: according to the national transport infrastructure plan, about €166 billion will have to be invested in the next 20 to 30 years on the development of transport infrastructures (excluding Greater Paris), of which more than 90 % will have to be spent on alternatives to road and air transport. Modernisation and renewal investments of €90 billion will be in addition to this amount.

• *Information and communication technologies*: in this sector, the existing (copper) networks are nearing the end of their life. A voluntarist national policy is being implemented to deploy fiber optic networks: between €20 billion and €30 billion will be required in the next two decades to cable the entire country.

Finally, it should be noted that environmental challenges increase the interdependence of infrastructure activities (e. g. "smart grids" solutions involving energy companies and telecommunications infrastructures; energy efficiency in the building sector, etc.), and that the business of the French companies involved is of a significantly larger dimension than the French market alone.

The supply of finance

As far as the supply of finance for infrastructures is concerned, there are a number of points worth underlining:

• Major operators that finance themselves on the markets provide a substantial proportion of the financing of new projects in some sectors (for example, in the last three years, the 12 main energy companies have invested €45 billion per year in Europe in gas and electricity production and infrastructures). The capacity of operators to raise funds on the markets is nevertheless limited compared with what is required. Furthermore, the tendency is for investment and operating functions to be separated.

• Public-private partnerships (PPPs) are in practice an appropriate solution for the completion of major projects. However, their financial profitability has to be assured in order to attract private investors, and this sometimes requires a large proportion of grants. Moreover, the formula is not able to cover the needs of multiple small-sized projects, which represent a substantial part of the overall need for long-term investment (in particular in the energy field) and which are only partially covered by bank loans. Nevertheless, PPPs are put in place to finance some small projects (prisons, hospitals, electric power stations, etc.). In the next 10 years, arrangements in the form of PPPs should represent, in France, investments of an average of between €5 billion and €6 billion annually. This forecast is in line with the situation anticipated in the next two years, namely three times the amount recorded for PPPs, excluding the outsourcing of public services, in the last few years.

• Institutional investors are looking for mature ("brown field") projects generating regular cash flows (with a view to investment for between 10 and 15 years). They have little appetite for project debt, which is much more difficult to analyse than company debt.

• There are now two new kinds [2] of very proactive investors who are increasingly making their presence felt. Investment capital funds are positioning themselves at the construction phase of new projects (with a view to investment for 5 years). Funds specialising in infrastructures are acquiring majority stakes in mature assets.

• The appetite of investors is inversely related to the duration of investments, which penalises some long term projects (for example, transport and energy distribution infrastructures).

• The scarcity of attractive projects for investors in Europe due to insufficient projected profitability, and investors' preference for international projects.

The drying up of public finances is an obstacle to the transition towards an economy more respectful of mankind and of the natural environment

Against a background in which public authorities have an increasingly short supply of finance, the financing of public services and of the ecological transition will be a crucial challenge for the next few decades. This will particularly affect investments in the training and education that are essential to ensure long-term competitiveness and growth, and the financing of the social infrastructures upon which the cohesion of French society depends. It will also affect the financing of the transition towards an economy more respectful of mankind and the natural environment.

With regard to this last challenge, a fair valuation of the resources and externalities upon which the profitability of investments depends should make it possible to alleviate the scarcity of public and private finance. Indeed, alignment of the financial and social returns of investment projects will be achieved through a fair valuation of finite resources and of the externalities generated, in particular from emissions. However, emissions, and particularly carbon dioxide emissions, are still inadequately priced, so that many private emission-reduction projects, which are justified from an environmental point of view, never see the light because they are not sufficiently profitable financially.

2 For example, in terms of numbers of projects, investment funds completed half of the main transactions that took place in 2010/2011, in an amount in excess of €10 billion in transport and the distribution of gas and electricity.

Without appropriate price signals[3]:
– research and innovation efforts are inadequate and too slow;
– private investments that would enable the energy performance of production processes and buildings to be improved remain insufficient or too costly for the public finances;
– transfers of traffic to low-carbon modes of transport are too limited; and
– planning and regional development choices fail to take enough account of environmental and social requirements.

The crucial challenge of mobilising national savings

Europe, and therefore France, is not well positioned in the international competition for capital flows

Europe's growth potential is structurally weaker than that of other geographical areas, in particular due to demographic trends. Furthermore, the crisis that it is currently experiencing is causing uncertainty that is bound to have an adverse impact on the behaviour of international investors. The latest statistics on the geographical direction of cross-border investments also show the relative lack of interest for Europe in comparison with other geographical areas.

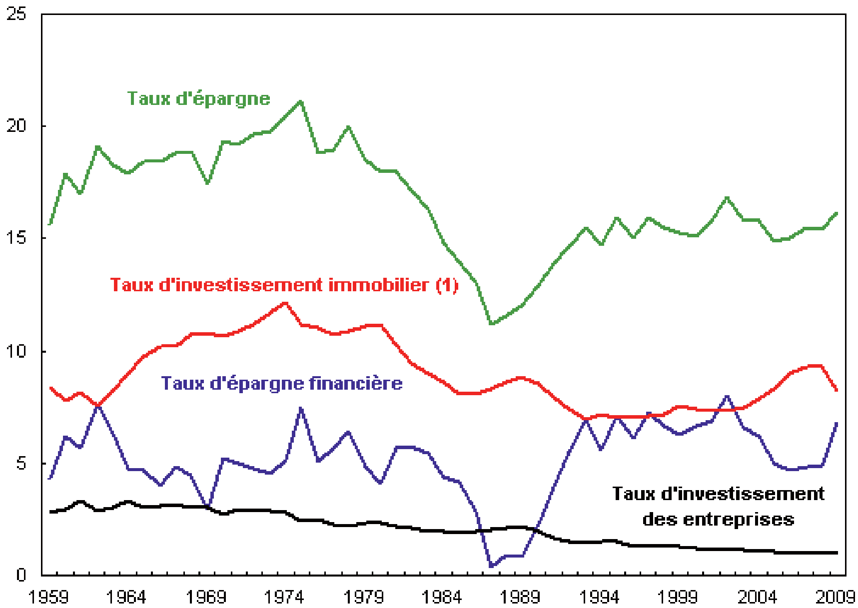
International investment cannot therefore make up, on a massive scale, for the insufficient capacity of domestic investment. Besides, it is attracted by domestic investment rather than being inclined to replace it. In this context, which is likely to continue, the challenge of mobilising national savings in favour of domestic investment becomes all the more meaningful.

Savings are abundant in France, but are insufficiently long-term in nature (apart from property investments)

Households' investments in property, in part consisting of fictitious rents when they are property owners, represent a substantial proportion of their savings and their wealth (about 70 %) with an annual rotation of about 2 %.

3 Conversely, excessive fiscal advantages and the juxtaposition of uncoordinated incentives granted, for example, to renewable energy projects, can lead to the appearance of bubbles.

Household Savings Rate



(1) rapport de la formation brute de capital fixe des ménages (hors entrepreneurs individuels ou revenu disponible brut.

Champ : France.

Source: Insee, comptes nationaux – base 2000.

According to data and analyses by *Banque de France*, intermediated investments by the financial system represent a preponderant proportion of the financial savings of households as is shown in the following table.

Structure of household investments at the end of 2006
(Amount in billions of euros and proportion in %)

	Amount	Proportion
Deposits and credits	1,007.4	30.7
Debt securities	168.8	5.1
Listed shares	336.4	10.2
Unlisted shares	13.8	0.4
Money market investment funds	110.6	3.4
Non-money market investment funds	414.3	12.6
Insurance products	1,234.8	37.6
Total	3,286.0	100

Note: in order to simplify this table, deposits and credits are grouped together. Nevertheless, when the category to which the creditor and debtor belong is taken into account, it is possible to distinguish clearly the nature of these transactions: deposits essentially appear among the liabilities of financial institutions, but can be owned by all kinds of parties, while credits are instruments for the financing of non-financial parties.

Looking in transparency through these intermediated investments makes it possible to see the real structure of household's financial wealth by instrument: in 2006, the listed and unlisted shares owned by households amounted to about €800 billion, or 25 % of their financial investments and the proportion of the final assets of French households financing non-residents exceeded 50 %, including nearly 30 % in the eurozone.

The crisis has had a significant impact on the allocation household investments

According to work carried out by Arrondel & Masson ("Savers in a world in crisis, what has changed" published by CEPREMAP in 2011), households have changed their savings behaviour and their choice of assets allocation following the 2008 crisis, and have tended towards greater prudence: precautionary savings are up, and there is a willingness to invest in more secure investments.

According to the analysis of these authors, which is corroborated by studies in Germany and the United Kingdom, these developments are not due to changes in the intrinsic preferences of households (risk aversion and pure time preference), but to negative expectations of labour income due to the deteriorating economic environment and of investment income due to the volatility of asset prices.

Longevity: an opportunity in terms of long-term financing needs

In theory, individuals are by nature long-term investors. This structural fact should be accentuated by the increase in life expectancy, which involves a more substantial transfer of resources from the period of activity to the period of inactivity. Three stages of life can be distinguished after retirement, which correspond to very different needs: active retirement; passive retirement; and dependence.

The way financing circuits are organised must support the phenomenon of longevity over time, and rely on the opportunities that it offers as well as on the new requirements that it generates. In particular, this can be done by:
– the promotion of existing retirement savings schemes (PERCO, PERP, PEE) while ensuring that they retain strong characteristics particularly in terms of the lock-up period, or even the introduction of new capitalisation pension funds in addition to the pay as you go system;
– the promotion of new investment vehicles with an assets and liabilities management well designed for the characteristics of such long-term savings. Funds invested in infrastructures should be considered with renewed attention because infrastructures as an asset class have many advantages for a long-term investor : a relatively foreseeable, because contractual, long-term recurring income; yields that are partially protected from inflation, with little sensitivity to the fluctuations of the financial markets, and which mainly arise from cash flows received in the course of operations (and only to a limited extent from capital gains); and a yield to risk ratio situated between that of bonds and that of equities[4]. It should be noted that the addition of infrastructures, which have a limited correlation with other asset classes, to an investment portfolio, makes it possible to increase the overall yield of the portfolio and to reduce its risk, giving such investments legitimacy from a financial point of view;
– giving consideration to improving the possibilities for households to mobilise their real property assets (the splitting up of beneficial and legal ownership; life annuities);
– coverage of the risk of dependence, which is a key challenge for the future. Care must be taken to ensure that the measures put in place include an element of capitalisation (linked to the pension) in order to limit the level of responsibility of the authorities (Social Security/Social Services) in a situation of very degraded public finances.

Incentives to increase long-term savings are structurally favourable for the long-term financing of the economy. But it is also necessary for the financial institutions that manage a very substantial proportion of household investments to carry out their intermediation and transformation role efficiently.

4 Investments in assets to be built are relatively more risky but can also be expected to be more profitable than those in mature assets.

The evolution of the role of intermediation and transformation in the financial system

The banking system's intermediation and transformation role will be profoundly affected by the new prudential standards (Basel III)

Banks play a particularly important role in the financing of the economy in Europe, especially compared to the United States: bank loans represent 164 % of GDP in the euro zone compared to 62 % in the United States.

Structurally, the heavy emphasis placed on accommodation and real property both on the part of households and of the banks consumes a large proportion of the resources that could be mobilised[5] for the transformation towards the long-term financing of other sectors (businesses, infrastructures, export financing and local authorities).

Against a very uncertain background, the banks are trying to reinforce their soundness by accumulating liquidity and by increasing their deposit base, including by transferring their customers' financial savings to their balance sheets. Moreover, they are limiting their exposure to the more risky assets. This phenomenon is accentuated by the development of prudential standards (Basel III), which could seriously hamper the banks' intermediation and transformation role:

• The conditions for financing the investments of SMEs and intermediate-sized companies through the banking credit channel characteristic of the economies of Continental Europe will get more onerous in several ways: an increase in margins which will add up to the foreseeable increase in interest rates, increased selectivity in the granting of loans and a shortening of the term of their loans.

• With regard to the financing of infrastructure projects, because of the crisis and the tightening of the prudential rules, loans granted by the banks are already more expensive. The level of risk premiums required on long-term project borrowing without recourse has increased compared to the equivalent government bonds. Their term is getting shorter (less than 10 years), which imposes a refinancing risk on the projects. Moreover, the financing of infrastructures under partnership contracts now requires more equity capital. Thus, for a project without a traffic risk, the equity capital requirement has increased from a range of between 5 % and 10 % to a range of between 10 % and 15 %. For a project with a traffic risk, the equity capital requirement has increased from 15-20 % to 20-30 %.

• Export credit financing, which is an important lever for the French trade balance and a major competitive issue for French banks, which have a strong international position in this area, will also be affected.

• The financing of local authorities, which is not very lucrative having regard to the illiquidity cost, has already been affected, hence the development of various initiatives aimed at finding alternative sources of financing.

The equity and bond markets do not enable the optimal financing of businesses in France, whether from a quantitative or qualitative point of view

Corporate debt (excluding financial institutions) only represented between 7 % and 15 % of issuances completed on the euro market between 1999 and 2011. Moreover, the primary

5 Margins in this area of business are historically low because property loans are used by banking institutions as a way of attracting customers and their account business. The substantial proportion of property loans handled by the banks is a significant risk factor in a context of very high prices, weak margins and extremely low interest rates.

and secondary corporate debt markets lack transparency and liquidity and the depth of the secondary market is insufficient.

It is very difficult for companies not large enough to access the stock markets and corporate debt markets, including those dedicated to such businesses, due to the unit costs of a initial public offering or bond issuance and of monitoring lines at institutional investor level. It is worth noting the recent European, and particularly German, initiatives to facilitate access by SMEs and intermediate-sized companies to these sources of financing, in particular via a network of regional stock exchanges. France is also looking into mechanisms that are suitable for its own economy.

The appetite of French households and institutional investors for shares, which was structurally already modest (in particular in comparison with their British and American equivalents), has been damaged by financial instability, which has become more acute due to the recent crises. The increasing volatility of the markets can be explained, in particular, by the increasing influence of short-term transactions in terms of volume, and particularly high-frequency trading, compared to the taking of positions based on an analysis of the fundamentals. This excessive instantaneous volatility of the markets compromises their ability to take on their role as a reference to provide information about value and their function of mobilising capital. It is also interesting to note that there has been an increase in interest among investors in the unlisted compartment, because it is not subject to this volatility.

The latest experiences between 2008 and the summer of 2011 have added a further dimension with the phenomenon of the instantaneous weakening of financial balance sheets fed by the largely procyclical nature of accounting and prudential standards. This situation has transferred to States themselves which have been placed in a situation of weakness due to their excessive indebtedness. The result is a dual effect of contagion and exclusion.

How to restore the efficiency of financial markets? An in-depth analysis of the financial markets during period of crisis should attempt to take into account, on the one hand, purchases and sales of securities of a lasting nature, and on the other, those which are only intended to exploit volatility in the short term, or even to create it more or less artificially. The question therefore arises whether the volume of short-term transactions, which has risen a lot for the last years in absolute and relative terms, should be limited, for example by way of the taxation of transactions or orders.

Securitisation: a possible solution difficult to implement and to consider carefully to avoid past mistakes

The restoration of securitisation transactions (potentially in the form of secured bonds) that are less opaque and better secured could give more flexibility to the management of banks balance sheets. In particular, it could be used to securitize bank loans to businesses, but also to the financing of small infrastructure projects with similar characteristics. These securitisation products will be difficult to set up due to the after-effects of the mortgage crisis in the United States, and more fundamentally, by the need to put carrying vehicles in place, with the dual problem of identification and assessment of the portfolio risks in a very uncertain environment, and the level of margin necessary to make products that achieve the profitability required by the markets after the inclusion of structuring and transaction costs.

In order to optimise the contributions made by long-term investors an accounting and prudential regulatory framework adapted to their economic models is required

Above all, long-term investors are characterised by the relative permanence of their resources, which is determined by their contractual commitments of liabilities to their principals[6] or the statistical stability of their resources. By virtue of this permanence, they are structurally less exposed to liquidity risks. In that respect, they differ fundamentally from other financial players that have to take more stringent precautions against short term refinancing risks. Since they are subject to fewer liability constraints in the short term, it is possible for them to disconnect the choice of their investments from considerations of their short-term financing capacity, and thus to optimise their allocation in the long term.

In comparison with other financial players, long-term investors are therefore, in theory, in a position to better exploit the very long-term superiority of yields of certain risky asset classes, and in particular of shares (*cf.* the 2009 report of the CAE "Long-term savings and management of financial risks" written by Olivier Garnier and David Thesmar) or illiquidities. In doing so, long-term investors contribute to the improvement of the inter-temporal allocation of resources, which is far from being optimal, since there is currently no market mechanism that enables one generation to share risks with the following ones: the absence in the markets of future generations, very concerned by certain uninsurable risks such as climate change and the exhaustion of resources, prevents the sharing of costs and benefits between generations.

The majority of long-term investors use two complementary approaches to manage their balance sheets. The first is based on their own view of the yields and risks associated with the various assets classes (internal model). The second aims to satisfy the regulatory requirements. The latter can prevail and lead to a very distorted allocation in favour of assets classes regarded as less risky, as is evidenced by the distribution of French insurance companies' assets in 2010. The tightening of the prudential constraints applying to insurance companies (Solvency II) in particular, has already had a negative impact on private equity, as is evidenced by the decline in the amounts invested by these companies in the last few quarters, which has contributed substantially to the developments described in this field in Part I above.

Structure of insurers' investments as at 31 December 2010 (detailed statements)

Before looking in transparency through investment funds

Shares	4.7 %
Investment funds	21.4 %
Property	3.6 %
Other investments	6.8 %
Other securities	0.05 %
Short-term debt securities	1.2 %
Long-term debt securities	62.3 %

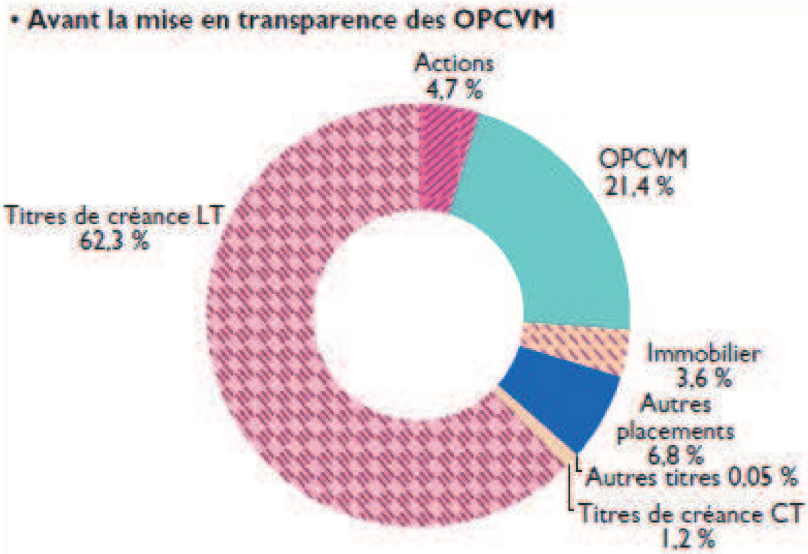
After looking in transparency through investment funds

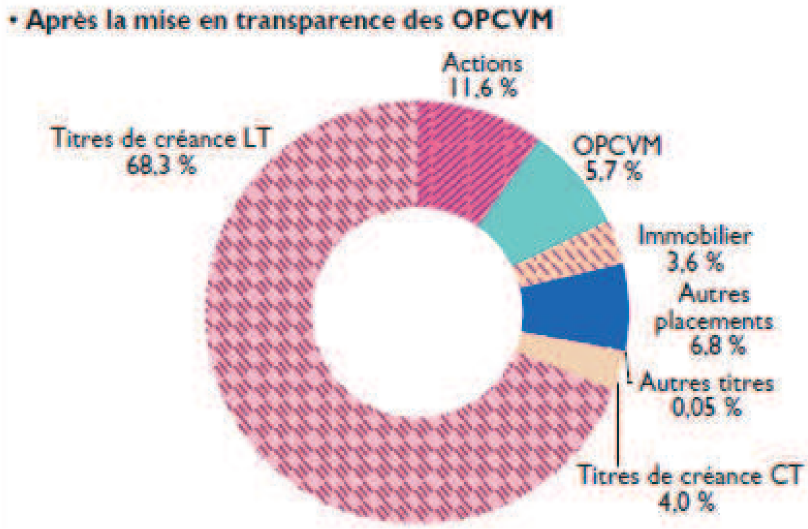
Shares	11.6 %
Investment funds	5.7 %
Property	3.6 %
Other investments	6.8 %
Other securities	0.05 %
Short-term debt securities	4.0 %
Long-term debt securities	68.3 %

Note : Total investments : €1,676 billion.
Sources : Prudential Control Authority, *Banque de France*.

6 The extent to which principals can contractually require payment of the resources constituting their liabilities is a key factor in their stability.

Insurers' investment Structure





Source:

Long-term investors with a view to lasting ownership and strategic support for the development of businesses get involved in the governance of such businesses and exercise a supervisory function in relation to them. The approaches to shareholder engagement implemented by a certain number of investors have a particularly important impact. This was pointed out by Hirschman in 1970, who showed that the capitalist system needs such investors who take a long view, with substantial shareholdings and exercise a supervisory function. They constitute the shareholders "voice" who play a role that complements the one played by the "exit" shareholders:

– "exit" shareholders express their opinion on a company by their buying and selling behaviour. By voting "with their feet" they contribute to the liquidity of the stock market;

– "voice" shareholders develop a deeper knowledge of a company's long-term sources of value creation, participate actively in general meetings and meetings of boards of directors, and perform a supervisory function in relation to the management.

Finally, long-term investors exercise a stabilising role in the financial system because they attach relatively more importance than other financial players to recurring cash flows (dividends and coupons), and thus to the long-term strategy of the business, rather than to capital gains. In doing so, they contribute to the efficiency of the markets by giving signals on businesses and projects that differ from those issued by operators taking a more short-term view. Moreover, they have a greater capacity than other financial players to carry risk over long periods and to ride out the impact of financial shocks through a policy of accumulation of reserves (in the good years) and realising capital gains (in the bad years) if the regulatory standards to which they are subject permit them to do so. They are therefore able to play a stabilising role in the markets since they can contribute to mitigating market fluctuations, particularly in times of crisis. During particularly bearish periods that oblige short-term investors to enter into “fire sales” to loosen their liquidity constraints, long-term investors can to a certain extent cushion an excessive drop in values.

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The European authorities currently have a historic role to play in mobilising the necessary resources to finance the priorities of the Europe 2020 strategy. In a context of scarce public resources, achievement of these defined objectives will require:
– the definition of policies in favour of innovation, sustainable infrastructures and the transition towards a more environment friendly economy, but also the prioritisation and selection of investment projects for the future. This will require in-depth cost-benefit analyses of such projects in advance, taking into account their socio-economic and environmental externalities within a consistent conceptual framework (*cf*. letter n° 8 from the *Conseil Économique pour le Développement Durable,* 2009), applied on a cross-disciplinary basis;
– the building of a regulatory framework understandable, stable and favourable to the long term financing of the economy;
– the efficient sharing of financing and risk between public and private parties. In this area, it is often difficult to achieve a balance, as is evidenced in the field of regulated infrastructures by the difficulties in finding the right level of yield to offer to investors via the pricing system, and by the complexity of the guarantee arrangements put in place;
– innovative financial arrangements based, in particular, on the potential coverage by the State of the most risky part, when such investments are justified from a public interest point of view. The pooling of investments with similar characteristics in securitisation arrangements, with the State assuming the most risky tranches, is an option to be considered. The proposed infrastructure fund, currently under consideration in France and to be set up in the form of a mutual securitisation fund, would operate along these lines. Some of the recent initiatives in the area of new financial instruments (project bonds) announced by Manuel Barroso, President of the European Commission, are along more or less the same lines.

Like any ecosystem, the financial system needs diversity in order to create wealth and be in a position to resist shocks. Accounting and prudential regulation must promote this diversity, particularly by allowing players with different economic models to express themselves in order to avoid the destabilising effects of short-term mimetic behaviour.

More generally, the authorities must find the right balance between protection against systemic risks, the solidity of financial institutions and the financing of the economy, which by its very nature implies a certain amount of risk-taking. This balance, which involves social choices relating to the sharing of risk between the community and its various constituent members, and more fundamentally still, in relation to our societies’ appetite for risk, is difficult to achieve, but it is vital that we achieve it rapidly because the future growth of our economies depends upon it.

Financial sector

What key recommendations can be made?

Rapporteur : Pierre-François Koehl

The long-term needs of the economy are not currently being properly satisfied, and this is compromising potential growth. In order to satisfy these needs, there are long-term investors capable of disposing of sufficiently stable liabilities to be able to manage their long-term assets without an excessive liquidity risk. Nevertheless, accounting and prudential regulations do not take account of the specific characteristics of such investors and in fact current developments are proving to be unfavourable to the long-term financing of the economy.

In an attempt to remedy this problem, it is possible to make four general recommendations, which could be acted upon in various ways:

– recommendation no. 1 : to reassert the necessity for a financial institution to assess the risks of assets taking into account the nature and the duration of the liabilities ;

– recommendation no. 2 : to design a model of assessment of financial risks that recognises the positive effect of long-term liabilities ;

– recommendation no. 3 : to include in the definition of long-term liabilities, which are essential to long-term investment, liabilities that are statistically stable in the long term ;

– recommendation no. 4 : to promote the creation of long-term savings by creating suitable investment instruments.

Fact: the approach to regulation – whether accounting or prudential – is proving unfavourable to long-term investment

The various regulatory developments underway – whether from an accounting (IFRS 9 and IFRS 4-phase 2) or prudential point of view (Basel III, Solvency II) – are likely to penalise long-term investment.

1. Market value accounting – which is the standard accounting method – results in the income statements and balance sheets of financial institutions being more sensitive to short-term fluctuations in the markets. It tends to blur the interpretation that can be made of the results of an investor's long-term strategy and to promote the adoption of procyclical behaviour on his part.

2. Prudential approaches are constructed by reference to a view of no more than one year (calculation of the value-at-risk, liquidity ratio), reinforcing investors' propensity to shorten their investment horizons.

3. In the case of Solvency II, the resultant capital costs to cover the various risks are proving to be universally heavy for investments in businesses and infrastructures, and all the more so when maturities are a long way off (treatment of business debts) (CGFS,

2011[7]), penalising sectors important for growth that are already dealing with a long-term financing deficit.

The combination of these various developments is in danger of causing the flow of long-term financing to dry up completely:
– banks will be more and more reluctant to provide long-term finance for assets using short-term liabilities, since liquidity ratios will make the banking transformation more difficult;
– it will become more expensive for insurers to invest in the economy long term: in Solvency II, market risk accounts for two thirds of the total capital requirement (Solvency Capital Requirement) and within that, equity risk, spread risk and interest rate risk are the three largest components (EIOPA, 2011[8]); while banks will tend to issue debt with a longer term, insurance companies, that already hold a lot of it, will not be encouraged to acquire it (IIF, 2011[9]).

Overall, the regulatory approach ignores the specific characteristics of long-term investment, and in so doing, risks making the sources of long-term financing of the economy even more scarce, when conversely, a suitable framework would be likely to promote it.

Recommendation no. 1: to reassert the necessity for a financial institution to assess the risks of assets taking into account the nature and the duration of the liabilities

If the current prudential approach is unfavourable to long-term investment, this is without doubt because, historically, it was constructed around the risks present on the asset side – the specific characteristics of various institutions' liabilities having been dealt with impliedly through the specialisation of regulatory frameworks:
– for banks, having liabilities dominated by sight deposits and short-term debt, the regulations put the accent on short-term liquidity risk and on short-term market risks;
– for insurance companies, whose obligations towards their insured constitute the bulk of their liabilities, the regulations focus on the short to medium-term solvency risk and on the proper ratio between financial assets and liabilities comprising risks associated with behavioural variables. In so doing, Solvency II takes into account, to a certain extent, the long term and proper match between long-term investments and liabilities, but considerably limits the possibilities of investing in shares, which are regarded as unsuitable instruments to deal with the non-financial risks present in the liabilities.

Insofar as long-term share ownership nevertheless appears to be a suitable investment strategy for an investor with long-term liabilities, how can account be taken within this prudential framework of the case of an investor wishing to own shares and justified in doing so having regard to his exposure to liquidity risk?

By dealing in this way with the specific characteristics of different institutions' liabilities, the prudential approach finds itself incapable of adapting to the different business models arising therefrom, and, in particular, of taking into account the long-term investors' model. *Mutatis mutandis*, the same analysis also applies to the accounting framework.

Even though, in the context of the current reworking of IAS 39, IFRS 9 on the accounting treatment of financial instruments theoretically puts the emphasis on the financial model

7 Committee on the Global Financial System of the BIS, "Fixed income strategies of insurance companies and pension funds", July 2011.

8 European Insurance and Occupational Pensions Authority, "EIOPA report on the fifth quantitative Impact Study for Solvency II", March 2011.

9 Institute of International Finance, Oliver Wyman, "The implications of financial regulatory reform for the insurance industry", August 2011.

– in the more restrictive sense of management intentions – in order to classify financial instruments, in fact it does not manage to take account of the specific characteristics of long-term investors' financial models – in particular as regards the treatment of long-term share ownership (cf. sheet no. 2) : thus, investors have a choice between the use of fair value through profit and loss (which results in its considerable volatility, which makes no economic sense in a long-term approach) or through equity (which then prohibits any recycling through profit and loss and thus prevents any measurement of the actual performance of the long-term investment). Neither of the two economic models used is relevant to long-term investors.

Recommendation no. 2: to design a model of assessment of financial risks that recognises the positive effect of long-term liabilities

The ownership of a long-term market liability involves an additional financial cost compared to a short-term market liability. All things being equal, financial institutions therefore have a tendency to favour short-term indebtedness – which increases the risks to which they are subject.

Illustration: let us suppose that an institution has 100 risky assets on its balance sheet; its liabilities break down as follows:

- equity capital (10);
- medium to long-term debt and short-term debt (90).

All things being equal, the institution's recurring profit will depend on the distribution of the financing between medium and long-term debt and short-term debt : the financial institution will, for example, generate recurring profits of 3 if its indebtedness is entirely short-term; on the assumption of a relatively flat rate curve (with a delta of 200 basis points between short and long rates), if it borrows solely on a medium to long-term basis, its recurring profit will be reduced to 1.2 (3-0.02x90). Thus, the institution will have a tendency to favour short-term indebtedness. But in so doing, it will also reduce its capacity to invest long-term.

In the second case, the institution of course generates lower recurring profits, but this average profit is assured for several years (since the cost of the indebtedness is itself fixed for several years); conversely, in the case of short-term indebtedness only, the average profits will be higher, but only assured for several months. It is therefore legitimate, from the point of view of the risks borne by the institution, to promote longer-term borrowing than that which this institution would naturally have a tendency to use.

What is true at the level of the institution is also true on a macroeconomic level : in an economy in which all financial institutions favour short-term financing, the impact of a crisis of confidence would be considerably amplified. What is more, since short-term financing penalises long-term investment, the negative impact in terms of the risk of a surplus of short-term financing would be coupled with a negative impact on growth.

Possible applications

In the area of prudential regulation

In the context of an earnings-at-risk[10] approach, a valuation could be carried out in a manner consistent with the duration of the institution's liability (for example, the profits-at-risk would be assessed over a 5 year period if that is the duration of the liability of the institution in question)[11].

In the context of a value-at-risk approach, a valuation could also be carried out in a manner consistent with the duration of the liability (VaR calculated according to a period equal to the average duration of the liability)[12].

Compliance with the solvency constraints could also be the subject of a long-term analysis: while Solvency II provides for a period of recovery of between 6 and 21 months, a longer period could be justified for institutions benefiting from longer-term liabilities (cf. the considerations concerning revision of the 2003 Pension Funds Directive – *cf.* sheet no. 3).

Also taking a long-term view, compulsory profit-smoothing mechanisms could be introduced: for example, a reserve to equalise investments could be constituted by a deduction from the profits at the time of their appropriation; it would only be written back to profits in the event of the realisation of capital losses, or in the case of latent losses, on investments.

Certain aspects of the risk can be the subject of a treatment specific to long-term investors: by taking account of a view extending beyond the economic cycle (rate risks); by basing oneself on the long-term modelling of risk premiums (share risks); by recognising the specific characteristics of specifically long-term assets (infrastructure risks) or by taking account of diversification (counterparty risks).

In the area of accounting regulation

In the area of accounting, it is appropriate to take account of the management intention by reflecting the lower short-term volatility of a portfolio managed for the long term – in particular by making use of the concept of utility value (*cf.* sheet no. 2) or by using HTM-type solutions for holdings. In particular, the accounting methods used must make it possible to pick up discrepancies that could arise over time with regard to the ratio between assets and liabilities, and to recognise the equalisation provisions made to absorb these discrepancies by reference to the forecast.

Recommendation no. 3: to include in the definition of long-term liabilities, which are essential to long-term investment, liabilities that are statistically stable in the long term

Long-term investment supposes the existence of long-term liabilities; but, apart from liabilities that have long contractual maturities, certain liabilities with short maturities

10 Such an approach is hinted at in Solvency II : the proposed version of the fifth test (QIS 5) provides for the Tier 1 equity capital to take account of expected profits included in future premiums. These EPIFP are the premiums that are yet to be collected on existing contracts. Discussions are underway at the level of the European Commission, to define the exact scope of these EPIFP.

11 In this respect, it should be emphasised that, among the avenues referred to by the participants in the consultation organised in connection with the amendment of the 2003 Pension Funds Directive, the account taken of the greater foreseeability of cash flows – in the same way as the account taken of the duration of obligations – is mentioned as one of the desirable adjustments to be made for the application of the Solvency II Directive to pension funds (cf. sheet no. 3).

12 From this point of view, a provision of Solvency II concerning the income from retirement savings provides for the (very restricted) possibility of dealing with risks present in the assets by taking into account the duration of the liability, indirectly (cf. sheet no. 1).

can also prove to be statistically very stable in the long term and thus can constitute an appropriate resource for long-term financing.

In a context in which sources of liabilities with long contractual maturities appear to be limited (*cf.* recommendation no. 4 on this point), the shortage of long-term investment results in part from the difficulties that can be encountered by financial institutions in mobilising stable liabilities in the context of financing long-term assets. With a view to increasing long-term investment, it is essential for the prudential and accounting regulations to fully recognise the possibility of using statistically stable long-term liabilities (which are also resilient in the short term in the face of financial crises, interest rate shocks, etc.), in addition to liabilities with long contractual maturities, for the financing of long-term investment.

From a prudential point of view, assessment of the asset/liability risk must be adjusted according to the structure of the liabilities – since management of the assets can be planned over time according to detected and anticipated variations in the stable liability. The managers of long-term investment will still have the time to take corrective steps, which should limit the loading of capital to cover this kind of risk.

Recommendation no. 4: to promote the creation of long-term savings by creating suitable investment instruments

Apart from mobilising stable long-term liabilities, increased long-term savings will be a natural source of growth for financial institutions' long-term liabilities. While savings are currently abundant in France, savings vehicles that can really be regarded as long-term appear to be relatively undeveloped (in particular in the absence of pension funds in France). The existing instruments are often complex and poorly explained, in a context in which liquidity is presented as a major advantage.

Now, where choices of savings are concerned, behavioural studies appear to indicate that in part, supply creates its own demand: in the absence of a perfect knowledge of his temporal preferences, individuals make decisions based on the context and give excessive weight to the present [13]. Thus, even if the individual's preference is for a long-term saving product (which he grasps more or less clearly), his "short-sighted" preference will depend, above all, on the context, and will tend to favour short-term effects (receipt of income immediately, even if it is lower than income at a later date).

Retirement savings are a natural source of long-term savings, which tend to lend themselves to an approach that is less constrained by the search for liquidity. It would also be possible to create a new investment instrument that would not give excessive weight to the present by putting the emphasis on liquidity : the income offered could be linked directly to the chosen investment timeframe ; in exchange, the short-term liquidity of the investment would not be assured.

13 L. Levy-Garboua, 2004, "Sequential perception and limited rationality", *Journal des économistes et des études humaines*. L. Levy-Garboua, M. Mangot, S. Rinaudo (November 2005), "Sequential perception, cognitive coherence and the primacy of the present over the future", Working paper.

Sheet no. 1

Example of an assessment of the equity risk taking the duration of the liability into account (Article 304 of the Solvency II Directive)

Article 304 of the Solvency II Directive introduces the possibility of taking the duration of liabilities into account to assess the risk to the asset. In fact, Member States can, subject to certain conditions, authorise life insurance companies providing retirement savings products to apply an "equity risk" sub-module calculated by using a measurement of the value-at-risk over a given period adjusted to the typical period of retention of equity investments by the company concerned. According to the EIOPA's opinion on this Article (29 January 2010), the capital cost can then be reduced to a minimum of 22 %.

However, this possibility is restricted to a particular case (retirement insurance products) and on relatively restrictive conditions (the average duration of the company's obligations in relation to these retirement savings activities must be in excess of 12 years). Under this mechanism, the duration of the liability is therefore only taken into account indirectly[14].

Article 304 – Duration-based equity risk sub-module *[the key elements of the provisions have been underlined by the rapporteur]*

"1. Member States may authorise life insurance undertakings **providing**:

(a) **occupational-retirement-provision business** in accordance with Article 4 of Directive 2003/41/EC, or

(b) retirement benefits paid by reference to reaching, or the expectation of reaching, retirement where the premiums paid for those benefits have a tax deduction which is authorised to policyholders in accordance with the national legislation of the Member State that has authorised the undertaking;

and where

(i) all assets and liabilities corresponding to this business are ring-fenced, managed and organised separately from the other activities of the insurance undertakings, without any possibility of transfer, and

(ii) the activities of the undertaking related to points a) and b), in relation to which the approach referred to in this paragraph is applied, are carried out only in the Member State where the undertaking has been authorised, and

(iii) the average duration of the liabilities corresponding to this business held by the undertaking exceeds an average of 12 years,

to apply an equity risk sub-module of the Solvency Capital Requirement, which is calibrated using a Value-at-Risk measure, over a time period, which is consistent with the typical holding period of equity investments for the undertaking concerned, with a confidence level providing the policyholders and beneficiaries with a level of protection equivalent to that set out in Article 101, if the approach provided for in this Article is only used in respect of those assets and liabilities referred in point (i). In the calculation of the Solvency Capital Requirement these assets and liabilities shall be fully considered for the purpose of assessing the diversification effects, without prejudice to the need to safeguard the interests of policyholders and beneficiaries in other Member States.

14 It is worth noting that, as the negotiations relating to the Omnibus II Directive currently stand, and in order to preserve the fairness of competition between pension funds and insurers developing an occupational pension business pursuant to Article 4 of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision (the IRP Directive), provision should be made for a transitional period (*a priori* until 2015) allowing such insurers to continue to apply the provisions of the IRP Directive.

Subject to the approval by the supervisory authorities, **the approach set out in first subparagraph shall be used only where the solvency and liquidity position as well as the strategies, processes and reporting procedures of the undertaking concerned with respect to asset – liability management are such as to ensure, on an on-going basis, that it is able to hold equity investments for a period which is consistent with the typical holding period of equity investments for the undertaking concerned.** The undertaking shall be able to demonstrate to the supervisory authority that this condition is verified with the level of confidence necessary to provide policyholders and beneficiaries with a level of protection equivalent to that set out in Article 101.

Insurance and reinsurance undertakings shall not revert to applying the approach set out in Article 105, except in duly justified circumstances and subject to the approval of the supervisory authorities.

2. The Commission shall submit to the European Insurance and Occupational Pensions Committee and the European Parliament, by 31 October 2015, a report on the application of the approach set out in paragraph 1 of this Article and the supervisory authorities' practices adopted pursuant to paragraph 1 of this Article, accompanied, where appropriate, by any adequate proposals. This report shall address in particular cross-border effects of the use of this approach in a view to preventing regulatory arbitrage from insurance and reinsurance undertakings".

Sheet no. 2

For an adaptation of IFRS 9 to the specific characteristics of long-term investments

The mechanism proposed by the IASB with regard to the accounting treatment of financial instruments (IFRS 9, which is a reworking of IAS 39) theoretically recognises the importance of the entity's business model since the latter classifies its long-term investments, first, on the basis of the objectives defined at the time of preparation of its business model, and then according to the contractual characteristics of the cash flow they produce. This classification allows one to determine whether a long-term investment must be valued at its fair value or at its amortised cost.

Nevertheless, in practice, the purpose of using the business model concept is above all to limit the possibility of using the amortised cost. Thus, the mechanism extends the use of fair value yet further in comparison with IAS 39. In particular, IFRS 9 provides that the principle of accounting at market value through profit or loss should automatically be applied, in particular to shares, even though these instruments are intended to be owned for a long time having regard to the business model with which they are associated. Of course, the provisions allow one to opt for accounting the variations in the value of the shares through equity, but this option is irrevocable and the performance noted at the time of the sale of the security remains definitively fixed in the equity capital (which is therefore not "recyclable"). While it appears to be difficult to reconcile market value accounting through profits and loss with the concept of the long-term investor, the alternative method prevents the long-term investor from measuring his investment's actual performance.

In its commentary on the IASB draft standard (21 September 2009), the EFRAG (European Financial Reporting Advisory Group) therefore suggested that more account should be taken of the business model when classifying assets. It did not support the proposal to exclude any recycling of the return through profit and loss in the case of accounting through equity, and instead proposed an extension, and simplification, of the existing AFS (Available For Sale) approach, which recognises the existence of "recyclable" equity capital.

However, it would be more satisfactory, in order for IFRS 9 effectively to take account of the specific characteristics of long-term investment, for a third accounting portfolio to be created in addition to fair value through profit and loss and amortised cost, which would be dedicated to long-term investments owned with a view to the medium/long term and which are managed on the basis of a business model that does not involve either the realisation of short-term capital gains or the collection of cash flow (cf. the commentary of the *Conseil National de la Comptabilité* on the draft standard).

This portfolio could be accounted for at a minimum between its acquisition cost and its value in use, with any depreciation recorded on this basis being accounted through profit and loss; latent capital gains would not be accounted for, but would be the subject of a note to the accounts. The utility value – defined as the current value of the cash flow expected from ownership of an asset (IAS 36) – would be determined having regard to the management intention in respect of the securities and according to an expert's opinion.

Another solution would be to value the securities at their market value, to store any latent capital gains or losses in equity capital but to account for any depreciation found on the basis of tests based on the value in use through profit and loss and to "recycle" any latent capital gains or losses of equity capital in the profits at the time of sale of the security.

Sheet no. 3

The avenues referred to in the EU debates on pension funds

In its green paper on pensions published in July 2010, the European Commission proposed a revision of the 2003 Directive on pension funds to take account of various new factors:
– the occurrence of a major financial crisis which had shown the importance of prudential regulations;
– the adoption of Solvency II Directive, which amended the standard prudential framework (the 2003 Directive based on a framework inspired by Solvency I);
– the development of defined contribution regimes which passed the risks onto individuals;
– the low level of development of cross-border business (one of the Directive's objectives), in part due to the failure to harmonise national regulatory frameworks.

The consultation on the harmonisation of the solvency rules applicable to institutions for occupational retirement provision (IORPs), launched in 2008, thus highlighted the necessity to adjust the Solvency II mechanism to take account of the specific characteristics of these institutions. Among the adjustments quoted by the Commission in its report on the replies given during the consultation, particular reference may perhaps be made to the following recommendations[15]:
– to take account of the long-term nature of IORPs' commitments – since taking a one-year view to assess their financial soundness could prove to be too short;
– to allow longer periods of recovery in the event of non-compliance (up to several years);
– to take account of the relatively high level of foreseeability of flows of finance.

A request for an opinion addressed to the EIOPA (European Insurance and Occupational Pensions Authority) was made in April, relating in particular to the question of the adjustments to be made to Solvency II. A request for contributions from the EIOPA on part of this question has just commenced (in its draft response, which appeared on 8 July, the Authority restated, in particular, the necessity for fair competition between the regime arising under Solvency II and that covering the IORPs). The final opinion of the EIOPA is expected by the end of the year.

15 European Commission, March 2009, "Feedback statement. Consultation on the harmonisation of solvency rules applicable to Institutions for Occupational Retirement Provision (IORPs) covered by article 17 of the IORP Directive and IORPs operating on a cross-border basis", page 10.

Tax treatment

The tax treatment of long-term investments

Rapporteur : Patrick de Fréminet

In a period in which there no longer appears to be any room for budgetary manoeuvre, proposing fiscal measures to promote long-term investment appears to present an impossible challenge. Austerity has become the new watchword, and it is more likely to result in tax increases (including tax breaks) than in a reduction of budgetary expenditure.

In addition, while the preoccupation to do one's best to preserve consumption and maintain standards of living is understandable, it nevertheless gives rise to a fiscal policy that acts to the detriment of savings and investment. Warnings must be given about the limitations of this strategic choice, which favours the short term over the long term.

Before making some modest yet essential proposals so that savers can at least remain hopeful if not confident, it is necessary to describe the political, fiscal and demographic framework of savings.

What is the general context in which savings are treated for tax purposes?

Emphasis must be placed on three points, respectively with regard to the weight and distribution of tax, the instability of fiscal legislation and the response to the demographic challenge.

Regime of products of savings and capital and income from employment

Can one continue to regard savings products and capital as benefiting from a more favourable regime than income from employment, and that there is therefore reason to increase the tax on the former to bring it into line with the tax on the latter?

This judgment, which appears to have inspired certain policies, especially since 2005, does not match the reality and for the most part simply begs the question.

1. First of all, international comparisons do not bear out the idea that French tax rules favour savings products. Appendix 1[16] shows that our tax rates on dividends are rarely lower than those of our partners, and that our capital gains tax rates are markedly higher. In addition, we do not have large areas of complete exemption from capital gains on negotiable instruments of the kind that exist in Germany or Austria.

Furthermore, we have a tax on capital that, among other things, applies to financial savings at a much higher level than that found among our neighbours (cf. Appendix 2). Thus, in

16 Appendices mentioned in the body of the text will be sent to interested parties, on request to : francois.calonne@caissedesdepots.fr

the last year for which figures are available (2008), we were at 3.4 % of GDP, compared to 0.9 % in the case of Germany, a European average of 1.5 % and an OECD average of 1.8 %.

2. When making the comparison between income from employment and income from capital, some people confine themselves to comparing 19 % (the tax rate levied at source [17] and on capital gains) with the rate of 41 % applicable to marginal employment income.

First of all, on the one hand this is a net rate, while on the other, it is a marginal rate. The average rate applied ordinarily is obviously much lower.

Secondly, in the case of income and revenue on capital, excluding property income, no management or acquisition costs are deducted (unlike the 10 % of salaries).

Thirdly, in the case of levies at source and fixed rates (capital gains), there is no annual indexation, unlike the sliding scale to neutralise inflation.

Fourthly, in the case of capital gains, the gain recorded is a theoretical gain based on face value without any indexation of the cost price. Of course, allowances (after six years in the case of capital gains on real and personal property) reduce the level of tax. Within the six-year period, the tax rate applies as much to the monetary capital gain as to the real capital gain. After that period, allowances are very low for real property (one has to wait for thirty years for the exemption).

One can reason in a similar way with regard to interest, where the flat rate applies to nominal interest without taking account of inflation. The conclusion is the same in the case of life insurance, where the income subject to income tax or to the fixed-rate levy at source is a nominal amount, the result of a yield over several years.

Finally, the social security deductions in respect of income from assets have constantly increased at a faster rate than those on employment income. Both started at 1.1 %, before stabilising at 8 % in the case of employment income, including 5.1 % of deductible contributions (2.9 % are non-deductible). In the case of income from capital, they have reached 13.5 % including 5.8 % of deductible contributions, and 7.7 % of non-deductible. It should be added that there is no deduction of social security contributions in respect of the flat-rate and proportional deductions. Thus, we have arrived at the current position, of a global rate of 32.5 %, or even in certain cases of 48.5 % (life insurance of less than four years) compared to a global rate of 46.1 % on income from employment, before taking into account the finance law for 2012.

Appendix 3 shows the figures for the net rates on income from assets which are the same as, or greater than, the ordinary employment income tax rates, and of course, some phenomenal increases. Thus, between 1989 and 2012, namely in 23 years, the capital gains tax rate on negotiable securities increased from 17 % to 32.5 %, or more than 91.18 %. No other tax has increased so much (the sliding scale rates have noticeably reduced).

Furthermore, we should not forget the tax on wealth (heavy in France) and the fact that savings originate from income after tax. In short, savings, which have already been taxed once, are simply consumption in the making, which must also justify a more limited level of tax.

The instability of fiscal and social security legislation appears to be incompatible with long-term savings, which need stability

Appendices 4 and 5 describe the various savings regimes and how they have evolved, especially since 2005. We will confine ourselves here to some significant examples.

17 This rate is expected to be increased to 24 % for income received with effect from 2012

Between 1966 and 2004, there was a stable regime of taxation of dividends with the tax credit. Since then, there have been three different regimes, without counting one-off amendments.

The rate of tax on capital gains from the sale of negotiable securities changed eleven times between 1989 and 2011. 1989 : 17 %; 1990 : 18.10 %; 1992 : 18.75 %; 1993 : 19.40 %; 1995 : 19.90 %; 1997 : 26 %; 2004 : 26.15 %; 2005 : 27 %; 2008 : 29 %; 2009 : 30.1 %; 2010 : 30.3 %; 2011 : 32.5 %, representing an increase of more than 91 % in 22 years, including social security deductions.

The sale threshold has been constantly amended, especially since 1993 (at least 6 or 7 different regimes), and disappeared entirely in 2011. The tax shield created in 2006 was extended in 2007, then reduced in 2009 and 2010, before disappearing in 2011. Is there any point in mentioning the tax breaks and how they have evolved? Having been enthusiastically created to channel savings, they are now universally condemned, just a few years later.

It is not surprising that this is all incomprehensible, or that the feeling of insecurity is getting worse. This is particularly the case since the corrections and increases have taken place little by little without any consideration of the past. What is one point or 0.5? But after five or six increases, one has the feeling that the movement is irreversible, and that savings are an inexhaustible source of tax and social security receipts, without any serious study justifying the policy or questioning its consequences.

Moreover, one cannot discern any common thread that would make it possible to understand the coherence of the whole. Thus, certain short-term, liquid and low-risk products have the benefit of tax regimes that are more advantageous than those applicable to long-term, and by definition more risky, investments which nevertheless make it possible to finance the economy and pensions.

• Against this background of general instability, and in spite of the continuous increase in social security contributions, there are some tax mechanisms or regimes that make an effort to mobilise long-term savings and thus to provide long-term and stable finance for the economy : PEA, PEE, Perco, SMEs and life insurance. The last product, in particular, has managed to bring in €1,300 billion to contracts that currently last on average for more than ten years, and which now represent the largest segment of long-term savings in our country. PEAs are obviously more modest, but nevertheless represent more than €91.7 billion, but invested solely in shares. Similarly, as at 30 June 2011, the outstanding amounts of PERCOs under management was €4.8 billion, and had increased by 40 % in one year.

In addition, retirement savings products have been developing for several years, though they are still limited in France in comparison with our European neighbours. It is therefore essential at the very least that the tax treatment of these regimes is not made worse, since they have demonstrated their effectiveness and are particularly useful for our country in the current economic circumstances.

The response to the demographic challenge

The demographic issue has become a major one, with the increase in average life expectancy. The fortunately peaceful stability of our societies makes demography an even more exact science.

The reform of pensions that proved so difficult arose directly from demographic changes. We all know that this reform is not complete. It is clear that the public sector, which is already heavily in debt, will not be able to take up the slack to deal with the new needs created by the inevitable ageing of the population, such as dependence, for example.

It is obvious that only household savings will be able to meet the needs arising from this demographic reality. Shouldn't this inspire a tax policy that favours long-term investment? For the moment, however, short-term budgetary preoccupations appear to be carrying the day. And yet, we can scarcely expect demographics to go into reverse. The change has definitively begun and it is up to politicians to adapt the major demographic trends rather than the other way round.

From this point of view, two of the measures to reform the tax treatment of wealth in the spring of 2011, in an area that is of course connected, left a bitter after-taste. In fact, while governments of both left and right had retained these measures, the law, on the one hand, abolished allowances for *inter vivos* gifts (or 30 % or 50 %)[18], and, on the other, increased the potentially exempt transfer period for *inter vivos* gifts from six to ten years. These measures encouraged early transfers of inheritances, precisely in order to respond to demographic changes which mean that people tend to inherit when their professional career is over, at aged 60 or 75.

Does not reducing these favourable regimes in order to finance a reduction in wealth tax, amount to sacrificing the long term for the short term, structural measures for those linked to the current economic climate, and future generations for the current generation ?

These policies are regrettable and are a bad sign in terms of reasonable account being taken of the demographic realities. As far as savings are concerned, the failure to give younger people the means to organise their family and professional lives will result in a loss of dynamism (business creation). The transfer of wealth is, in itself, positive.

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On the basis of this first part, it appears that action should generally be taken along the following lines:

– first, to halt the inexorable increase in the taxation of savings and capital, wrongly presented as gradual ;

– to restore savers' confidence by allowing them to commit for the long term and by abandoning the constant legislative instability resulting from increasingly speeded up "stop and go" movements ;

– to introduce global consistency into the tax regime for savings : long-term products financing the economy should obviously benefit from more advantageous tax treatment than liquid, short-term and less risky products ; and

– finally, the mechanisms to deal with the unavoidable reality of demographic changes and the definite incapacity of the public sector to respond to them, must be adapted.

Proposals

The working group has discussed a number of courses of action, some of them very bold. However, due to the economic, political and budgetary circumstances, it has only adopted a few significant measures, which though modest, are structural. The idea is to give the right signals and a message of hope in order to encourage long-term, stable savings. Symbols are important in this area.

In comparison with the current situation, the objective is obviously to increase the proportion of long-term savings. It is also necessary to consolidate those that already exist and consequently, to avoid tightening the tax treatment of products or contracts that have shown themselves to be effective. Finally, in the future, tax reforms must be consistent as a whole.

Subject to this constraint, we will distinguish measures affecting households, those directed towards SMEs and those concerning large businesses, in particular in the financial sector.

18 Except partially for transfers of businesses.

Measures affecting households

Two such measures more particularly attracted the group's attention. The first is to encourage private individuals of modest means to increase their medium to long-term savings.

1. A clear policy of favouring liquidity encouraged by an exceptional tax and social security status (*livret A*) was noted. In general, the more long-term the savings, the more they should be encouraged from a fiscal point of view.

Secondly, modest savers have lost a substantial proportion of their advantages in relation to the ownership of negotiable securities. Thus, the modest repayable credit of €115-230 on dividends, which was very largely compensatory for taxpayers exempt from income tax or paying very low amounts of income tax, has disappeared. Similarly, the threshold on sales of negotiable securities (€25,830) which enabled them to avoid tax at the rate of 32.5 % on capital gains, has been abolished.

Thus, capital gains are taxed from the first euro at the compulsory rate of 32.5 %, which is guaranteed to discourage taxpayers otherwise exempt from income tax.

It has been suggested that the tax credit of €115-230 could be restored, but reserved for households earning less than €1,525-3,050 in dividends, having an income not exceeding the limits of the 14 % threshold (€26,420), and which are not liable for wealth tax.

Moreover, while restoring a disposal threshold appears to be difficult, taxpayers whose income does not exceed the limits of the 14 % threshold could be offered the possibility of opting to have their capital gains taxed as income.

Such measures, which could be targeted to reduce the cost, are intended not to discourage households with modest incomes from saving, particularly in the form of shares. In this respect, these are both fair measures and educational measures aimed at young households. They are the households that will be tomorrow's shareholders; however, unless they have been in contact with negotiable securities at a young age and when starting out in life, it is not very likely that, when success comes, they will turn to such investments spontaneously.

2. The second policy in favour of households is on a larger scale and more complex.

In general, tax security remains essential for all medium or long-term investments. When a commitment is made over time with the prospect of a "profit" to be made – and therefore to be demanded – upon maturity, it is important that the State should refrain from amending the tax conditions that will apply to the outcome while the commitment is still in place. Nevertheless, experience has shown that this rule is not always observed. In addition, it now comes into conflict with the regular increase in the size of social security contributions.

What is needed is to give a certain volume of savings a guarantee of tax and social security stability. This volume could be allocated to several savings products or media (shares, long-term bonds, etc.) within one contractual commitment, regardless of whether ownership was direct or indirect.

This volume, which could be frozen for a certain period to be determined, would be covered by a commitment from the State with regard to tax treatment and social security contributions, without any change affecting the income from such savings. This would not be an exemption but a tax and social security "standstill". In general, the more long-term the savings, the more they should be encouraged from a taxation point of view.

While, in the case of the first of the above measures, the educational aspect was aimed at households, in the case of the second, it would be aimed more at the public authorities, which do not tend to regard tax treatment, *a priori*, as a contractual matter.

Measures affecting SMEs

In this area, it is necessary to take proper account of the characteristics and problems specific to such companies, independently of the fiscal issues.

The first measure is of general application and is intended to steer investors towards SMEs, while the second is targeted more at the creation of businesses and at direct participating shareholders.

1. The two existing tax credit mechanisms, one relating to wealth tax, and the other to income tax, cannot be cumulated on the same capital increases. They have demonstrated real effectiveness with regard to companies deprived of access to the markets, and increasingly, to bank loans.

However, these mechanisms have been reduced in importance in the name of combating tax loopholes. It seems to us that the risk taken by investors and the investment's long-term lack of any liquidity are such as to justify an improvement of the current regime (upper limits and rates of reduction) if not the complete re-establishment of tax reductions.

The second positive measure would be to allow payments in excess of the investor's wealth tax contributions, or an amount of €45,000, to be carried forward for two or three years in the case of wealth tax as they currently are in relation to income tax. In this way, one would avoid the fiscal "salami slicing" of capital increases and would enable companies to obtain the necessary capital more quickly. The paying up of shares over time is the source of conflicts and defaults.

The third measure is more innovative but does respond to a genuine need expressed by SMEs, many of which regard bond issues as the way forward in the area of financing. This measure would involve reducing income tax and wealth tax on long-term investments in bond products (bonds issued directly or collective bonds for several businesses owned directly or through an investment trust). In fact, SMEs sometimes hesitate to increase their capital too much in view of the risk of the founders losing control of the business. Conversely, banks encounter more difficulties committing themselves to long-term equipment loans.

Of course, the bond products would have to be clearly defined and retained until maturity.

2. It is suggested that we take inspiration from foreign regimes (and in particular the United Kingdom and United States) to develop the creation of businesses with rapid growth (so-called "Gazelle" businesses), which traditionally, have been too weak in France. What is needed is to enable companies to achieve a capital of the order of two million euros, which is a level likely to interest outside funds.

The idea would be to reinforce the existing measure to opt for partnership status, created in 2009 (Article 239 *bis* AB of the French General Taxation Code). This regime, which was inspired by the American one, is too limited in time and, above all, only allows the founding directors and shareholders, and not non-business individual investors, to deduct losses from their overall income. In fact, such a deduction is not possible from overall income, but only from income of the same nature, that is to say non-business income.

This slight amendment is certainly not a costly one, it merely involves transforming that income or those losses into ordinary business income.

Measures affecting businesses, in particular in the financial sector

The first measure affects all businesses and relates to dividends not covered by the parent company regime. The second measure is specific to businesses in the financial sector and is linked to the prudential and accounting regulations.

The dividends regime

The abolition of the tax credit (in 2005) seriously penalised businesses through their investment portfolio. Until that time, they actually had a tax credit equal to the amount of tax on their dividends liable to corporation tax at the ordinary rate. *A priori*, in a profit-making situation, the effect was completely neutral.

Under the new regime, they have to deal with a completely double taxation situation, because unlike private individuals, they have no allowance to offset the corporation tax paid by the distributing company.

For all practical purposes, (cf. Appendix 5 p. 1), and before taking into account the new surtax of 5 % provided for by the 2012 finance law, the rate of tax they pay is 57.01 %, which is completely confiscatory and well above the old rate of 50 %.

We suggest that companies should at least be given the allowance of 40 % that benefits private individuals. It would be even better to allow all companies to benefit from the parent company regime, as is the case in certain countries.

Financial institutions

A recommendation has emerged from the work done by Working Group No. 2, intended to allow institutional investors (pension funds, insurers, etc.) to create an equalisation provision – or reserve – the purpose of which would be to cover the risks attached to their investments.

In fact, because of the nature of their activities and the necessity to diversify their investments, such investors are particularly exposed to asset risks (issuer default, financial market volatility, etc.). Such events result in impairments being recorded by way of provisions or through the realisation of capital losses that can represent very substantial amounts that can put a serious strain on the financial year in question. This concentration of the depressive effect is even more inopportune – and disturbing for the market – if it takes place against a background of stock market turbulence, and thus at a time when the stabilising role of these institutional players is particularly important.

The idea, therefore, is to set up, and progressively constitute, a counter-cyclical prudential mechanism for investments intended to cover the costs arising from such impairments or capital losses in relation to investments, when the time comes.

At the same time, it is important to retain a suitable tax treatment for such a mechanism.

Conclusion

The expression "*Il ne fallait pas désespérer Billancourt*" [19] used to be very much in vogue. It is tempting to say, in keeping with the style of the present day, that we should also not "*désespérer la veuve de Carpentras*" [20], and in general, all savers. The stock market and financial crises have already largely taken care of reducing their resources and their number.

This is the gist of the first message that we wish to send to the authorities. We absolutely must stop giving the impression that it is inevitable that long-term savings, and particularly financial savings, face a rising tide of tax and social security charges. Fiscal stability and security justify both the cessation of negative measures and the creation of areas of lasting security of tax and social security measures.

The second message is to respond to future challenges by encouraging today's modest savers to familiarise themselves with long-term investments, which appear to them to be obscure and risky.

The other way to prepare for the future is to try to respond to inevitable demographic changes (retirement/dependence) through long-term savings, supplementing state insurance

19 Billancourt (town next to Paris) was the Renault cars main plant, symbol of the French working class ; the expression (from Jean-Paul Sartre during the 1968' events) means that it is politically wise to avoid driving the working class to despair.

20 Literally "Don't despair the widow of Carpentras". In France, the widow of Carpentras refers to the archetype of small and inexperienced shareholder

schemes, for example by setting up a favourable regime for income from long-term investments in shares, or by improving the tax regime applicable to life annuities.

The third message is to promote the creation and growth of SMEs, the fabric of which is traditionally weak in France and which encounter enormous, if not insurmountable, difficulties in accessing the markets or obtaining bank finance. It is therefore essential that we develop alternative and innovative methods of financing for such companies (and in particular, bonds).

The fourth message is both to stop penalising investments in shares by businesses in general and to enable financial businesses to cover the risks of their investments by making equalisation provisions.

Due to the budgetary context, the proposals remain modest, and may in some cases even appear to be symbolic. But symbols are educational, and what is more, when the measures suggested are based on long-term concerns, we believe that they are worth taking into account.

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