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"Long Term Investing - What can the EU learn from the Kay Review?"

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Executive Summary

Thierry Philipponnat said the event aims to build a bridge between the UK's Kay Review and the European Commission's upcoming Green Paper on Long Term Investing. He said Finance Watch's definition of investing can be summed in its motto "investing not betting".

Professor John Kay said that market integrity, liquidity and price discovery are only *intermediate* objectives and that the fundamental goals of the equity market are to have high performing companies and to transmit their earnings to savers at minimum cost. He said the chain of intermediation of equity markets is too long and too expensive, which creates problems of cost and miss-alignment of incentives. The most important players in the equity investment chain now are large investment managers.

There is a dysfunctional cycle of earnings management, centred around quarterly reporting. Companies try to manage investors' expectations in ways by creating activity such as M&A with little connection to the underlying value of the business. Equity markets have come to be dominated by other people's expectations and are disconnected from the asset and securities that are actually being traded. A second problem is the pursuit of relative as opposed to absolute performance: he said there is no *alpha* for the market as a whole. The only way for fund managers to improve their absolute returns is to improve the underlying asset class as a whole but the benefit to any individual fund of doing this is extremely small.

Policymakers should not try to generate rules to govern behaviour but create market structures that incentivise the markets we want. He said the shift from a relationship to a trading and transaction culture erodes trust and confidence. Asset managers need to be committed long-term holders of material stakes in companies and have more focused portfolios which are more differentiated from each other. If this happens many channels of intermediation will fall away. The results should benefit end-users not market participants.

Sharon Bowles stated that a lack of growth is one of the greatest threats to stability. One aspect of short-termism is high frequency trading (HFT), whose benefits can be questioned. Better price discovery is not the same as value discovery. There needs to be a return to long-term behaviour and investment and policymakers have gone astray. Too frequent reporting, even in the interest of transparency, encourages short-term horizons in the thinking of executives.

She used the bond market to explain that regulatory rewards for hedging mean investment takes place via derivatives, draining liquidity from underlying instruments. Bowles suggested a few solutions such as levies on disclaimers or complexity or giving equal treatment to real economy hedging rather than synthetic hedgers.

The European Parliament has tried to encourage direct capital investment in CRD4 by lowering the risk weights for SMEs, trade finance and long-term projects. In the CSD dossier, the Parliament has also been working on securities lending and the encumbrance of bank assets. She added that she thought bank bonuses should be paid in subordinated debt.

She called for greater simplicity, noting that the Volcker Rule and Vickers had become very complicated. Simplicity in finance could reduce measured GDP but not necessarily useful GDP. There should be more attention to absolute value and less to relative value. Simpler markets, products and investment chains would allow less regulation and a safer environment.

In the panel discussion, Trelawny Williams agreed that complexity undermines confidence and that simplicity should be a regulatory objective in itself.

Philippe Herzog said that investment should create durable growth and this can mean delayed profitability and high cost. A high dependency on and low supply of bank financing is a big problem for SMEs. Herzog said that the question is whether investment is a transaction or a partnership.

Jerome Hass said that finance is not in sync with the real economy and said the question is whether the industry wants to change the way it fundamentally operates.

On accountancy standards, Bowles said there is some “time travel” going on in accounting standards, bringing future cashflows forward to today, which hurts future growth. Kay said that accounting standards are seeking objectivity and relativity at the expense of relevance. They are primarily so people who know nothing about the assets can trade them but this is not a proper policy objective. Philipponnat said that the time horizons of risk assessment and accounting should be linked to the underlying business cycle. Kay said that fair value accounting gives companies a way to say whatever they want. Herzog argued that fair value accounting is useful but it should be targeted so as not to contradict the economic value and long-term assets should be evaluated in a different way. Hass said accountants should not guess what the fair value is, that is the job of the investor and intermediaries.

Herzog said prudential regulation shapes behaviour. Basel is not just complex; the calculation of risk is left to the industry. This is wrong. There needs to be a new type of financial mediation in Europe so that savings go to investments.

On fiduciary duty, Kay said this is one of the most important reforms. Fiduciary duty is interpreted unduly narrowly or not applied at all. In English common law, fiduciary duty means putting clients’ interest first, eliminating or disclosing conflicts of interest and not profiting from them.

Bowles said debt is given better tax treatment than equity and Kay said it would be a good idea to look at this.

Asked to give one solution each, Herzog called for a revival of the economy for investment not consumption. Kay said reforms should address structure and incentive, not behaviour. Hass called for action on accounting, prudential, tax and regulatory regimes of holding shares. Williams backed the idea of “career shares” for remuneration. Bowles argued for greater simplicity.

Keynote Speech

Thierry Philipponnat, Secretary General, Finance Watch

Thierry Philipponnat welcomed Professor John Kay, a distinguished economist, journalist and academic, and the author of the Kay Review, and Sharon Bowles, the Chair of the Economic and Monetary Affairs Committee in the European Parliament, and a pre-eminent figure in the field of financial regulation in Europe. He said that the event would draw lessons from the Kay Review in the UK and what the EU can learn from it. Kay and Bowles are the ideal pair to discuss this.

Long-term investing is high on the agenda of European institutions. The European Commission is preparing a Green Paper on the topic due in December. This session aims at building the bridge between the Review and the situation in Brussels.

Philipponnat said that it is important to understand what is meant by long-term investing. There are two popular definitions of both long-term and investing. Long-term is defined by the World Economic Forum (WEF) as "investing with the expectation of holding an asset for a very long period of time by an investor with the capability to do so." This is a very interesting definition with far-reaching consequences. The second definition would define long-term as “merely the succession of short-term periods.” This is clearly different and is the prevailing definition in today’s financial markets. That has implications for the discussion today. The definition of investing may not be as obvious as it sounds. There are two possible definitions, firstly, "bringing capital to productive use with the objective of creating a partnership between the investor and the underlying project.” The other definition is “choosing an asset with the unique view of deriving profitability or benefit by diversification regardless of whether the capital is brought to productive use or not.” It is easy to guess which definition Finance Watch prefers, based on its motto “investing not betting”.

One of Professor Kay's dominant views is that it is better to regulate structure than behaviour. Regulation is more likely to succeed if it works with human nature and not against it. People should not be stopped from responding to incentives, but the right incentives must be put in place. This type of thinking will resonate within Brussels and the wider European Union.

Philipponnat said that the conference had two objectives: To contribute in a meaningful way to the thinking behind the question of bringing capital to long-term investment; and to be concrete and realistic in coming up with ideas that can be implemented in the European Union, taking into account the specificities of the European Union, such as the different legal and tax systems of the 27 Member States, which can make things more difficult. The challenge is to take the fundamental ideas and convert them into realistic and implementable solutions.

Keynote Speech

Professor John Kay, author of ‘The Kay Review of UK Equity Markets and Long-Term Decision Making’

Professor John Kay said that the brief he was given last summer by UK Secretary of State for Business Vince Cable was to look at the impact of the functioning of equity markets on long-term decision-making by British companies. There was a need to look at how markets were functioning with respect to ultimate users: the companies that make use of equity markets and the savers with pensions and other long-term financial objectives. Markets have to be looked at through the eyes of market participants. Much of the discussion around financial markets relates to the efficiency of markets and issues of market integrity, liquidity, price discovery and so forth. These are *intermediate* objectives to the fundamental goals of high performing companies and the returns savers earn from that. This is the perspective that has led to the development of Finance Watch, the perspective that markets are for users not for participants.

Professor Kay said that he was asked to look at the impact of markets on the performance of UK companies. He said that he would talk about the report and stick for now to the UK perspective, he might hint at how Britain differs from EU Member States and other countries, but he will discuss what can be done at the European level in the discussion panel later on.

The state of the UK equities market

Kay said that when he looked at how UK equity markets function there were several factors, some of them surprising, that jumped out. As a source of finance for investment in British business equity markets are of no significance, large companies in the UK are basically self-financing. That is true of the corporate sector as a whole and of a vast majority of the companies within it. Rights issues and new issues by established listed companies are basically non-existent in the UK. If one were to strip out the rescue rights issues for the banking sector, in which the bulk of the capital provided was by the UK Government, one discovers that over the last two decades the net issuance of equities in the UK markets has been negative, not positive. That is, the amount of equity that has disappeared through acquisitions and share buybacks is greater than the amount raised by the markets. The IPO market of new listings by British companies is almost non-existent. Many large institutions describe it as a buyers strike. Investors have been sufficiently burned by low quality issues being made to them that they are no longer interested. While there are quite a number of new listings on UK markets they are not listings of UK or European companies, nor are they issues of industrial companies. Put simply, the stock market as it operates today is not a means of putting money into UK companies it is a means of taking it out. There is nothing wrong with that but it shows that the role of markets is different to the one that is taught to people learning the basics of finance.

The second discovery Kay made is that the structure of the holding of shares in the UK has changed radically. 50 years ago British shares were held by private individuals. That changed, and 20 years ago the dominant holders of equities were British pension funds and insurance companies. That is not true anymore, partly because regulation and other decisions have led these institutions to reduce the amount of equities they hold, partly because these institutions have diminished as a proportion of total savings, and partly because many of these institutions have outsourced the activity of equity management. Now the important players in the equity investment chain are large investment managers like BlackRock, Fidelity, Vanguard, Legal and General, M&G. The top six institutions account for nearly half of all ownership of UK shares.

The chain of intermediation of equity markets is too long and too expensive. The people who matter are the companies at one end and savers at the other. Between companies are savers there are intermediaries like registrars, asset managers, pension fund trustees, investment consultants, platforms, independent financial advisors etc. The list could go on. All of these people require their own legal staff, their own compliance officers, their own accounting support, and so on. The length of the chain creates two groups of problems: firstly problems of cost, and secondly the mis-alignment of incentives. Each intermediary has its own business model, which does not necessarily correspond with the objectives of companies and savers.

In summary, equity markets are secondary markets, asset managers are the important players in the investment chain, and that equity investment chain is itself too long.

Long-term decision making

The second part of the brief given to Kay was to ask how these factors impinge on long-term decision making by British companies. It impinges in three primary ways.

One of the reasons why equity markets are not very important as a source of capital for British business is that nothing is important as a source of capital for British business. Business in modern European economies is much less capital intensive than it once was. Tangible investment is not as significant as it once was. Britain is firmly at the bottom of the league in terms of the share of investment in R&D; the US is second bottom. This may be a coincidence, but it is worth noting.

Kay said that he is more concerned about investment in intangible assets such as investment in skills and capabilities and reputations that companies enjoy with customers and suppliers. It can be seen right across the corporate sector the extent to which companies are willing to sacrifice that reputation in return for short-term share price growth. The extreme example of this is in the financial sector where trust has been eroded. These intangible assets have declined in volume in pursuit of earnings and share price growth. That takes one to a dysfunctional cycle of earnings guidance and earnings management, centered around quarterly reporting. This creates an incestuous symbiotic relationship between sell-side analysts and the investor relations departments of companies, in which companies are trying to manage investors' expectations, and analysts are trying to manage each other's expectations in ways that create activity with little connection to the underlying value of the business. Just look at the number of cases of companies which reported quarter-by-quarter growth in earnings in line with market wants and expectations until suddenly they didn't. It is an indication that what is going on is not something that is telling you about what is actually happening about the company but something that is being done in order to manage expectations.

The third area that is a problem is hyperactivity. The word used in financial circles in London to describe mergers and acquisitions (M&A) activity is “corporate activity”. The question to ask is what happened to Britain’s largest companies of 20 years ago? The answer is that they do not exist anymore as independent businesses, the remnants of the businesses are to be found scattered among other players that is the first issue of the difference between Britain and Europe. Hyperactivity is a characteristic of a great deal of the way in which corporate executives relate to equity markets. Many corporate executives are obsessed with this sort of activity. They see themselves as meta-fund managers, managing a portfolio of businesses, rather than as an asset manager managing a portfolio of stock. That is not what business is about. Little if any value is added by this activity.

The concerns about long-term decision making relate to investment in tangible and intangible assets, the cycle of earnings management and they relate to the hyperactivity in the M&A market.

Market dysfunctionalities

The fact that investors may have short-term time horizons does not mean that the companies they invest in have matching time horizons. The point of equity markets is to allow companies to raise long-term capital without necessarily locking investors in to very long-term investments. Nevertheless there is a relationship, and it is necessary to understand what that is in order to understand the mechanisms that have created these problems. There is huge uncertainty about the evolution and development of any large, complex business. There is a value discovery horizon in which, with a great deal of uncertainty, markets discover what the impact of a company’s evolution might be.

There is also the issue of performance horizon: What is the time period over which an asset manager might be in charge? If the performance horizon is long relative to the value horizon then what the asset manager is incentivised to focus on is the process of value discovery, understanding the real value of the company. The shorter the period of the performance horizon the more the asset manager is concerned not with the impact of the actual value of the company but on the change in market expectations about the value of the company. The shorter the performance horizon the more important it becomes to understand what other people think about the value of the company rather than what the value of the company actually is. It is a situation that is encapsulated by Keynes's ‘beauty contest’, where people are making their choices based on what other people think, and on what other people think other people think, and so on. Equity markets have come to be dominated by other people's expectations and are disconnected from the asset and securities that are actually being traded.

The second dysfunctionality of the market is the pursuit of alpha, relative output performance. Each asset manager, to try and sell their product, emphasise their performance relative to a benchmark or the average performance of other fund managers. The pursuit of alpha necessarily totals up the zero. If fund managers are to improve their returns the only way to do it is not to achieve alpha, it is to achieve beta, the underlying asset class as a whole. The benefit to any individual fund of doing this is extremely small.

Solutions

There are two broad themes in the solutions to the problems. The first is the issue of trust, confidence and respect in financial markets. Some think this is just a public relations problem. It is not. You do not persuade people you are honest by telling them how honest you are. Trust and confidence is generated by behaviour. It will not be restored until there is a change in the behaviour of the financial sector. It is depressing that the new Financial Conduct Authority (FCA) is tasked with maintaining confidence, its task should be to maintain *justified* confidence, which is something entirely different. Trust and confidence are essentially the products of personal relationships, or of personal relationships amplified by organisational structures that are so organised that the behaviour of one member of the organisation is representative of the whole. The shift from a relationship based world to a trading and transaction based culture erodes trust and confidence. Trust cannot be generated by trading between anonymous agents. There is no trust and confidence in a dark pool. To address the issue there has to be a rethink of financial intermediation based on relationships rather than trading or transactions.

The second issue relates to incentives. When this issue is raised people's minds immediately turn to bonuses, but it is not all about that. Most people in most businesses are behaving in the way they are expected. If they are not, then it is because the environment they are working in is wrong rather than because those working in the sector are wicked people, even if there are wicked and unpleasant people working the financial sector, the vast majority of people working in the sector are decent people who want to get on in a good job. People behave as one would expect them to in the environment they find themselves in. This discovery has profound implications for financial sector regulation, because the whole thrust of financial sector regulation for more than two decades has been to allow the creation of industry structures that create perverse incentives and then to draw rules to prevent the undesirable behaviour produced by these perverse incentives. That system is doomed to failure. The response to this failure has repeatedly been to advocate a more elaborate and complicated set of rules to make the system work. The problem is in the structure than the rules. That is the process by which Basel II was more complication than Basel I, and Basel III was more complicated that Basel II. He predicted that when the next banking crisis hits there will be a Basel IV that will be more complex than Basel III. It is time to think not about detailed rules but about addressing structural problems.

The phenomenon of the UK equity markets, also true in the US, has been to give primacy to the role of asset managers. Asset managers must have the right styles of behaviour and the right incentives to generate long-term investment. Asset managers need to be committed long-term holders of material stakes in companies, asset managers with more focused portfolios who are more differentiated from each other. If this happens a great deal of the channels of intermediation would fall away because they do not need to be there. There are there to generate layers of oversight because whenever there are perverse incentives more people are needed for oversight, and every additional layer creates a need for another layer. There should be a simpler, shorter, less expensive chain that is more focused on asset managers with more concentrated and focused portfolios that are more differentiated from each other. Policymakers should not try to generate rules to govern behaviour but create market structures that create the markets we want. The end results should be for market users rather than market participants. Companies have, for practical purposes, ceased to use equity markets for finance. Returns earned by savers have been extremely disappointing and financial market participants have done extremely well. This situation is not sustainable.

Keynote Speech

Sharon Bowles, MEP, Chair of the Economic and Monetary Affairs Committee

Sharon Bowles said that she does not know what is going to be in the European Commission Green Paper on long-term investment, but she had a lot to do with the fact it is being published. She set long-term investment in a tighter regulatory framework as a priority two years ago as a key response to the Commission. Back then markets were already experiencing perverse incentives as a result of financial regulation.

Bowles said that she would be commenting on the same issues as Professor Kay, but on how those affect the work that is already underway and is planned. There is an undoubted dilemma on the requirement of regulation to achieve financial stability because it impinges on growth at a time when lack of growth itself is one of the greatest threats to stability.

The continual growth of short-termism in financial markets presents huge problems, most obviously for stability and providing reassurance to end investors who fund by saving the economy and financial markets. One aspect of short-termism is high frequency trading (HFT), an area in which Finance Watch has a lot of work and where many now question whether it gives any benefits at all. It may mean better price discovery, but that is not the same as value discovery.

Other aspects include banks, traders, asset managers, hedge funds and pension funds. A big determinant of this is the regulatory environment and the response this regulation forces. What might also be called the complexity war has compounded the regulatory response, which in turn impacts the investment chains that are relied upon. There needs to be a return to long-term behaviour and investment. The points raised here show where, with the best of intentions, policymakers have gone astray. Too frequent reporting, even in the interest of transparency, encourages short-term horizons in the thinking of executives. Reconfirmation of directors at AGMs does the same as people seek to please in order to get re-elected. Quarterly reporting extenuates this. Moves to annual reporting may help in this regard.

Another of the recommendations is the Kay Review concerned the dematerialisation of shares. This issue is already before European policymakers now, in the regulation on Central Securities Depositories. Bowles said that she has received input from back home that demateralisation is far too unpopular a measure for any government support. Secretly many hope that Europe will be brave enough to do it and take the blame.

Fragmentation of the investor base is seen as a disadvantage of long-term investment and understanding of a particular company, but when looking at prudential requirements she is interested in the diversity of portfolios. In some regulations, such as Solvency II, diversity is recognised in many ways. It was much too hard to implant recognition for specialisation, which was deemed unmeasureable or too correlated. When looking at assets in a long chain of intermediation the reliance on numerical measures or indicators becomes dominant over knowing the business, hence in all regulation there is a reliance on knowing those measures to the extent that the simply knowing the business is crowded out.

Engagement is seen as vital to long-term interests. The European Parliament has been trying to pursue relationship lending in the context of the Capital Requirements Directive IV (CRD IV). They are coming up against the supervisory attitude of “how is that to be defined and measured?”

Following the financial crisis there has been a lot more concentration on liquidity in regulation, pressing towards trading and the easily tradable. Other prudential regulation clamps down on the instruments designed to help businesses but not deemed to be fully loss absorbing.

Bonds are rendered more liquid by the derivatives that surround them, which make a simple product more complex. This is a situation that is encouraged by regulation. It might be simpler if bonds were made for a range of transactions, but liability immunisation is not done that way for a variety of reasons: Long bond purchases can be hedged with futures contracts to effectively reduce the duration, and they will receive a regulatory reward for hedging. Short bond purchases can be hedged as well for a regulatory reward, and in the middle of this the banks make a happy profit. The bond investment chain is not short or simple, and trading takes place with derivatives rather than the investment themselves. When derivatives have more liquidity than the underlying assets they drain away liquidity that the assets would have.

Bowles suggested a few solutions such as levies on disclaimers or complexity or giving equal treatment to real economy hedging rather than synthetic hedgers. Complaints arose that you could get perfect hedgers by using capital investment and that the regulatory advantage would therefore not apply. Regulation has to change to allow it.

Direct capital investment has been encouraged in other countries through monetary policy and window guidance. Some of this has already been happening with the assets that qualify for repo transactions. The European Parliament has tried to do its own encouragement, through risk weighting in CRD, lowering them for SMEs, trade finance and long-term projects. This is not the perfect solution but the Parliament is looking for ways to boost long-term investment.

Greater complexity makes it harder to assess true value. There has been greater reliance on relative value, based on benchmark based investing. The index or benchmark has no true anchor, it is simply an average that is often so complex that no one can understand it. This is why Bowles has been promoting transparency for benchmarks in MiFID.

Another issue is the separation of economic interests and legal title of securities. Not long ago some investors did not know that the shares they lent out to facilitate short-selling could be voted. Now there is more awareness of the need to recall shares. Similar questions arise when looking at the repo market and other forms of securities lending. In the Parliament Bowles has been trying to start some information gathering or reporting of securities lending in context of CRD IV and getting a grip on the encumbrance of bank assets. More of this will be done in CSDs.

Others investment choices are made through price/earnings ratios, which factors in earnings beyond five years. There should be no more “cash flow time travel”, bringing tomorrow’s earnings forward for consumption today. Growth is scarcer now because of this.

There is a need to look at bankers’ bonuses. Bowles suggested in 2010 in CRD III that payment of bonuses should be in subordinated debt, but it was watered down by the UK and the Financial Services Authority (FSA), but it is now back on the agenda in CRD IV with the backing of the Bank of England. These instruments must be bail-inable to have a limit on the coupon and to prohibit derivatives that would in effect transform it away from the risk.

To address wider issues of short-term culture a war must be waged on complexity. Some of the change to simplicity might manifest itself as a reduction in measured GDP but not necessarily a reduction in useful GDP.

There is no future in Brussels saying that there should be less regulation, but there should be more awareness of what it is doing. For assets there should be more attention to absolute value and less to relative value. For regulation there should be simpler markets, simpler products, and simpler investment chains leading to less absolute regulation and more relative regulation and a safer environment.

Panel Discussion

Tools available at EU level to stimulate long term investing

Panellists

- Professor John Kay
- Sharon Bowles, MEP
- Philippe Herzog, President, Confrontations Europe
- Jerome Hass, President of the French Accounting Authority, ANC
- Trelawny Williams, Global Head of Corporate Finance, Fidelity

Moderator

- Thierry Philipponnat, Secretary General, Finance Watch

Summary

Philippe Herzog said that long-term investing is high on the agenda. The European Parliament has done a lot on the matter but the European Commission and Member States are not ready.

Speaking on the definition of long-term investment from the real economy side, we want the perspective of durable growth, often this means delayed profitability and high cost. The gap is not between corporate and financial investors, although there is a problem of alignment of interests, but the gap for SMEs is tremendous.

Herzog said that he would focus on three points:

1) Accounting standards – Economic and financial value is not the same thing. Firms like Thomson have faced devaluation by the market saying it was worth €1 at one point but €2-3 million a few weeks later. The connection between public policy and financial accounting has not been made. It all depends on IRFS standards – Europe must gain control. Full fair market value should not be confused with economic value. The IRFS value is the wrong structure.

2) Regulation and structures – Banks must be looked at. Before the crisis 2/3rds of financing came from the banks and this has since fallen. This is not a problem for large corporate firms but it is a big problem for SMEs. Asset managers are not giving the right answers. Why not promote the role of institutional long-term investors. Public banks can have a major role because they have long-term liability and they can match the problem of taking risks on long-term assets.

3) Public environment – The issue is not sufficiently on the top of the agenda. Take Project Bonds for example, it is still an experiment. The Commission is not facing the challenges of adequate savings policies. The building of European investment funds will depend on American private equity. Can we really achieve the goals regarding the financial structures necessary without having a real strategy regarding the investment in skills and infrastructure?

Trelawny Williams said that the Kay focus on market structure rather than market behavior, and this approach should be applauded. Many of these issues describe human interaction and human behaviour. Blunt intervention can have unforeseen circumstances. Mandatory disclosure of directors' pay is an example of this.

Williams said that he supports 14 of the 17 recommendations in the Kay Review, is neutral on 2 and is against just 1 (the proposal for an investors' forum). Speaking in an EU context, it must be recognised that different jurisdictions have different market structures. In culture, a one-size-fits-all approach will not be appropriate. He would be cautious about advocating a lot of up-front legislation. The investment industry must be persuaded that many of the recommendations have merit and they should take steps of their own volition to implement some of the changes, with a specific threat to implement regulation if there is not progress over a certain period of time.

Williams recommended that equity incentive rewards should be restricted to career shares held at least until termination of employment. This mirrors Fidelity's internal approach, by locking in and aligning the interests of mangers and shareholders in the long-term and simplifying the issue. Complexity is the enemy of accountability. The only recommendation that should be opposed is the Investors Forum, which he questions is workable.

Jerome Hass said that finance is not in sync with the real economy. Finance clashes with the real economy. The question is how to get control back. Accounting has become a tool for finance. The IFRS standard setters think that companies do not say the truth and that has to be counterbalanced by people who say an indisputable truth. The statement is flawed.

There are solutions, some of them to do with changing concepts. Instead of looking at a screen to assess value, why not take two more minutes and think about the value of a product. The question is whether the industry wants to change the way it fundamentally operates, with all the intermediaries etc.

The G20 Communique of April 2009 had a good sentence about taking into account the time horizon of the investor. The question is whether there is the political will and technical ability to do that.

Thierry Philipponnat asked whether current regulations and accounting standards are neutral and could neutrality be lost with a change in regulation.

Sharon Bowles said that regulation is not neutral. The press for liquidity is not neutral, there are problems with that in banking regulation and Solvency II. It cannot be said that it does not have an effect on the balance of long-term vs. short-term. There is still some time travel going on in accounting standards. Mark to market is good, it's just you cannot trust the mark to market. It all comes back to the need for simplicity. She said that back when she was on the Legal Affairs Committee (JURI) she would try to get rid of the legal spam. High complexity leads to a high number of disclaimers. If these disclaimers become illegal then a lot of the complexity would disappear because all the lawyers would get scared.

Herzog said that the way accounting standards are applied can have huge implications on reputation. Investing in equities is not a good bet for the long-term. The profession was not neutral as it was commonly thought that equities were the best bet for the medium/long-term, which was false. The question is whether investment is a transaction or a partnership. The value at risk should be considered on a five year cycle rather than every year.

Professor John Kay said that a neutral regulatory structure would be one in which people made the same decisions they would have made without a regulatory regime. No one would want to impose a neutral regulatory regime. The whole purpose of regulation is to change behaviour.

The direction of regulation in financial services is to try and be neutral towards market structure and regulate behaviour. That is the route that has led to disaster, leading to unsustainable financial conglomerates that created problems in the financial system. There should be a non-neutral simpler regulatory structure.

Hass said that passing neutral legislation could create legal problems, with lawyers trying to second guess it. That is a plea not to over-regulate. IFRS and other regulations, like the liquidity requirements in Basel III, are like trying to wear shoes that do not fit you for running a marathon. Paul Tucker of the Bank of England has called for the abolition of IFRS if it is necessary and moves to a "common sense" approach.

There is a lot of variety of structure in European Member States and this has to be taken into account. There are objective differences that could call for differences in legislation.

Kay said that accounting standards are seeking objectivity and relativity at the expense of relevance. It is primarily so people who know nothing about the assets being traded can trade them. That is not a proper public objective.

Williams said that he is suspicious about how companies seem to be able to smooth their earnings and come in slightly ahead of consensus again and again. Some of the accounting in banks is particularly concerning. Some banks have passed stress tests only to require market support and come close to failing soon after. There is much less faith than there used to be in the accounting profession. Accounts should be presented as they are not how people would like them to be. Some of the changes are very sensible for financial stability reasons but too much discretion is given to organisation as to how they present their figures.

Philipponnat said that if regulation is not neutral today that non-neutrality may as well be pushed towards long-term investing. The time horizons of risk assessment and accounting should be linked to the underlying business cycle. That poses a number of difficult technical questions because risk and success still need to be measured. How do we do that? One of the legitimate reactions to calls to abolish fair value accounting is how to ensure that investors, insurance policy holders and consumers are still protected from the inevitable fact that institutions will try to benefit from the fact that time horizons for accounting have been pushed back. How do we reconcile two contradictory objectives, to push money to long-term investment but protect investors, retail investors and consumers?

Bowles said that she does not suggest getting rid of fair-value, but the fair value should be a real value. It is dangerous to say that long-term investment can only be dealt with by pushing into the future the definitions of what values are. It is a question of stripping away layers of complexity in derivatives that modify the value, so there is a more naked approach to things. It is not easy to get the regulation right. It gets more complicated in Solvency II when trying to match investments and liabilities. The duration approach still has not been solved. Policymakers should not throw out fair value or mark to market, but look at what is in it.

Kay said that fair value accounting gives companies a way to say what they want. It should be recognised that timescale varies dramatically. Auditors should be thrown back into the business of whether accounts provide a true and fair reflection of the company. Accountants have been trying to duck their liabilities by following proscribed procedures. Companies like Fidelity should negotiate the kind of information that sophisticated investors need.

Williams noted that it is about the quality of the information rather than the quantity.

Herzog said that the view of long-term investment must be changed to come back to the valuation of the projects that are supposed to be in the public interest in the long-term. The sum of value added receipts must be calculated in the long-run. If the real valuation for society cannot be calculated the auditors will not do it; it must be clear. The discount rate is a huge problem. It is not something that can be set by the markets.

Fair value accounting is useful but it should be targeted so as not be in contradiction with the economic value that is needed. Long-term assets should be evaluated in a different way; the specificities of investors should be recognised. Each country has its own way of defining its own priorities on investing. Each country has its own way of giving value to this. There should be a common body of accounting to reconcile this.

Hass said fair value is not the devil. If someone is in the business of making money in the market, what they do can only be shown by the market. The problem is that market price measures lots of things that are not market activities. These valuations are not relevant.

There was a debate in the House of Lords today about how accounting led British banks to wrongly value their provisions of bad loans. That is critical to taxpayers.

Hass asked Williams how a long-term investor can be satisfied with short-term metrics.

Williams said that Fidelity uses a methodology of in-depth analysis that talks to management. Analysts will come out of that process with a good idea of which businesses work. The investment thesis will be a medium to long-term thesis. This creates a price target of what Fidelity thinks a company is worth. There will be occasions where the share price rises above value and the long-term investment becomes a short-term investment as shares are sold and redeployed elsewhere.

Hass commented that there is a difference between the value a company has according to a large investor like Fidelity and the value according to the market. Accounting should be more modest, the more it looks into the future the more wrong it becomes. Accountants should not guess what the fair value is, that is the job of the investor and intermediaries.

Questions were asked about how long-term investment could be incentivised for retail clients, what the panel thinks about introducing a work order for tax advisors, how fiduciary duty impacts long-term investment, whether there is any point left in equity markets, whether Kay's recommendations would be difficult to get through because of certain agents being happy with the status quo and whether retail investors should invest in liquid assets, leaving large intermediaries to invest in long-term assets, or whether retail investors should invest directly in long-term illiquid assets.

Williams noted that there is a conflict because most retail clients are not long-term. Many customers will move elsewhere if they get the chance.

Kay said that a process of financial education is needed that investment performance should be evaluated over minimum of 3-5 years. Firms like Fidelity have to be a part of this. Adverts that promote the short-term have to be stopped. Financial advisers are part of the problem; they derive income from persuading people to churn their portfolios. Often doing nothing is the best option. He does not believe that the requirements of retail clients are particularly diverse. Well written computer programmes can often give people a lot of help in getting to the right structure. That is true for most of the market.

Hass said that technology can create bad incentives. Products must be sold properly. Legally in Europe regulators have the power to do that. A new directive is not needed.

Herzog argued that equity is needed for the real economy. Education is a real problem. MiFID was a disaster; no transparency, volatility of market price, nobody could see what was happening. The ability to give advice was kept by the banking industry; they did not want any regulation. Advisers were not skilled to give any advice.

There needs to be a savings policy. There are instruments which could help people solve problems of dependency and so forth. Targeted saving should be built. This is not just a problem of asset management. The business model should be of public concern. There cannot be trust without knowing the business model.

Bowles noted that MiFID and PRIPs are coming for retail investors. There will be a lot more work done on transparency so one knows that if an adviser is advising something it is because it is good for the customer rather than good for him. One of the things there is a problem with is how often an investor has to be told about performance. Bowles suggested that there might be fewer fees if this was less frequent.

On fiduciary duty, it should be looked at who the duty is to: is it to the company? Is it to the shareholder? It is important to get back to a situation where equity is king. Debt is given better tax treatment than equity. Interesting things can be done in terms of encouraging savings – such as having compulsory saving. Though Europe is not in the right economic circumstances now where those kinds of experiments will work, they have been used in Scandinavian countries in the past.

In terms of getting investors interested in infrastructure, it could be done with a focus on localism. It is harder to invest is a project far away than in a local project. There is a lot more that can be done that can also be helpful with the simplicity agenda.

Herzog argued that the institutions that manage savings keep liquid and illiquid assets at the same time. People can understand that if there is some security behind it. Liquidity today and tomorrow is not the same as liquidity in the medium- and long-term.

Williams added that too much focus on liquidity can give rise to unconstructive behaviour and facilitate HFT, which a lot of people have questions over. Proponents argue that it provides liquidity, but when market conditions get tough HFT disappears.

Kay said that Europe has seen the death of equities and that is something that should be reversed. The banking sector wants equity but cannot get it. Banks will claim that the cost of equity capital to them is some absurdly high figure like 15 per cent. If investors really expected a 15 per cent return on investment in banks, there would be queue of people around the block trying to put money in. Investors no longer have serious confidence in these institutions. These problems will not be solved by tinkering around with the tax treatment, although it would be a good idea to look at the relative tax rates of debt and equity. The only solution is to build relationships based on trust and confidence.

Philipponnat asked how trust could be restored.

Kay stated that restructuring the financial services industry is a 20 year job. Kay said that he goes to conferences on Basel III but "wants to turn out the lights on all this". It is irrelevant. Solvency II is rubbish. Insurance companies do fail, but not for the reasons that Solvency II seeks to protect against. They fail either for reasons of fraud and mismanagement or because assets and liabilities that were supposedly uncorrelated are in fact correlated. The same is true in disclosure requirements for retail investment. There are a great number of structured products in the retail market that no one in their right mind should buy and nobody that understood them would buy. Regulation is intrusive and expensive and everyday growing more complicated, and yet in achieving the real needs of consumers it is not remotely close to doing the necessary job.

Questions were asked about the political will to change the system, whether new economic models are needed, whether there is a place for cooperative banks and mutual in retail investment, what the difficulty is in adjusting accounting regulation in terms of the business model framework, and what the panel thinks about the report from the Liikanen Group.

Kay said that things have changed in Britain over the past few months and there is now a public understanding that what went wrong in the financial sector was not just the result of one or two bad apples, and that if only Fred Goodwin had not been in charge of RBS all would have been ok, but that the problem is the culture of large conglomerates. Politicians have been reacting to that, which is why it became possible for Bob Diamond to be forced out of Barclays.

Kay said that he is one of the only people to have done work on where GDP figures actually come from. The largest leap there has even been in the contribution of financial services to GDP happened in 2009 over 2008, and the biggest quarterly rise happened in the fourth quarter of 2008. These are not numbers to be taken very seriously. He does take seriously the idea that the UK has a competitive advantage in financial services, even if a lot of it isn't very useful Britain is selling a lot of it to foreigners who are willing to pay for it.

Fiduciary duty is a big issue; sometimes it is interpreted unduly narrowly and sometimes it is not applied at all. Fiduciary duty is one of the most important tools in creating a financial sector that is available to people. It is a duty to put clients' needs first and eliminate or disclose conflicts of interest and not to profit from them. It would be good if these standards were imposed across the industry.

Herzog stated that accounting standards are very important, but public calculation is even more important. It determines the type of measure one wants to have. Public calculation does not just need good accounting, but fair pricing. For example, if there is no carbon tax, carbon is not well-priced. GDP is needed but it should be corrected when questions like energy and so on are faced. National accounting was not able to give answers to the questions of natural capital and material capital. There may be some need for public involvement.

Herzog said that he agrees that prudential regulation shapes behaviour and does have an impact. Basel is not just complex; the calculation of risk is left to the industry. This is wrong. There needs to be a new type of financial mediation in Europe so that savings go to investments.

Philipponnat asked what the silver bullet is to facilitate that new type of intermediation, and Herzog argued that there should be a mixed view. Institutional investors need to do their job not only on delegating mandates to asset managers but in developing their own type of calculation and intermediation for long-term investment.

Williams said that there is a need to use all the tools available, including anti-trust law. Complexity does undermine confidence; simplicity should be an objective in itself. If rules are simple it reduces the options for gaming the system. Shareholder engagement also plays an important role in the process of rebuilding confidence.

Hass stated that it is important to know the business model one has in mind and the representation of business models that people have in society. It has to do with incentives. The regulatory response as it is today is not producing the type of change that the panel would like to see in the long-term. The question is what can be done. Bad attitudes should be punished.

Bowles said that she is not prepared to wait for simplicity and has started to act upon it. The European Parliament is already fixing CRD IV and has even got to benchmarking of supervisors but the Council do not like it.

GDP figures are a problem and the fact that people cannot pin down what GDP is, is a concern. Particularly considering the measures around economic governance that are high on the agenda at the moment, it would be a good idea to get a handle on that. Some countries will take fright when they see the trade figures that say exports of financial services are down because policymakers have opted for more simplicity, but there might be more genuine trade to balance that, so it is something that must be done for stability.

When it comes to financing energy there will need to be some sort of state involvement but it is good to have the EIB and similar banks with expertise, and it is good that institutions like the EIB are being used a lot more in partnership with the state. She is not a great fan of public-private partnerships because the private sector negotiators run rings around the public sector, so the negotiators need to be professional.

On Liikanen, Bowles stated that the problem with both the Volcker Rule and Vickers is that they became horribly complicated. Ideas that were quite simple were made complex. She likes that at first glance Liikanen looks simpler and that there are aspects in there that are led from the point of view of the resolution plan. The remit on competition will not do more on banks unless there is a financial stability component of competition policy. This is something that could be looked at during the next revision of the Treaty.

Philipponnat asked the panel what one measure they would suggest to solve the problems discussed today.

Williams recommended the adoption of career shares, held until the termination of employment. It is deliverable and would go a long way towards addressing issues of remuneration.

Herzog recommended a revival of the economy for investment, rather than trying to sustain consumption. To promote investment when there is a huge aversion to risk there needs to be some choices of investment in the public interest. There should not be new financial innovation. It can be useful, but the political body should define the investments needed in energy and skills precisely to address the main problems.

Kay said that the scale of capital needed for long-term investment in business is actually very modest. First, the proportion of banks' balance sheets that accounts for lending to non-financial businesses is 3 per cent. There is more than enough capital to invest in infrastructure and get the gummed up channels of intermediation out of the way. Second, the financial sector is mostly about trading existing assets. Third, regulation should focus on structure. None of Volcker or Vickers or Liikanen will work. They are going in the wrong direction. They should address issues of structure and incentive rather than creating yet more complicated rules that lead to perverse incentives.

Hass said that he would focus on the accounting, prudential, tax and regulatory regimes of holding shares. Much as he agrees with what has been said, there is too much liquidity around and the instruments are not in the right hands.

Bowles argued that it is all about simplicity, removing disclaimers and layers of complexity that are doing no good.