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The Long-Term Financing of the European Economy: the views of the Italian Banking, Insurance and Finance Community

Italian Banking Insurance and Finance Federation

Rome, October 2013

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* FeBAF stands for the Italian Banking Insurance and Finance Federation

Foreword

The Italian Banking, Insurance and Finance Federation (FeBAF) is an organization born under the aegis of an "alliance" between the Italian associations of financial firms. The Italian Banking Association (ABI) and the National Association of Insurance Companies (ANIA) founded the Federation in 2008. The Italian Association of Asset Management (Assogestioni) joined it in 2011 and the Italian Association of Private Equity and Venture Capital (Aifi) joined in January 2013.

FeBAF aims at providing – with the full involvement of the member associations – a forum for enhancing the dialogue with the Authorities and other stakeholders. The idea is to build a "common house" for the savings industry in Italy. Since its inception, the Federation has been promoting the vision of a modern, efficient and sustainable financial sector in Italy, which is required for supporting economic growth and social progress in the country. In coherence with its mission, FeBAF has taken a leading role in the discussion on long-term investment and the ways to finance it.

This volume presents the position paper proposed by FeBAF in response to the European Commission's consultation on the Green Paper on Long-term Financing of the European Economy on behalf of the Italian Banking Association (ABI), National Association of Insurance Companies (ANIA), Italian Association of Private Equity and Venture Capital (AIFI), Italian Association of the Investment Management Industry (ASSOGESTIONI), Italian Association for Complementary Pensions (ASSOPREVIDENZA), and Public Company for the Development of the Italian Pension Funds Market (MEFOP). It includes also other papers from the Italian Financial Community and papers from relevant European Business Associations. The urgency of a smart, sustainable and inclusive economic recovery has been advocated in the Europe 2020 strategy and reiterated in the Green Paper.

Long-term finance is vital for sustainable and sustained growth and for the lasting recovery of the European economy. We are conscious of the need to ensure the sustainability of public finances and to reduce progressively the public debt/GDP ratio. However, economic policies founded exclusively on fiscal austerity and consolidation have not been able to reach in full their objectives. A mix of structural and short-term policies should be designed and implemented. The EU consultation allows to focus on the complementary relationship between the short and the long term. In Europe, especially in Italy, we need a long-term perspective to re-start a path of sustained growth.

First, the Federation's contribution on the Green Paper on Long-term Financing of the European Economy draws on the point of view of its affiliated Associations: ABI, ANIA, AIFI and ASSOGESTIONI. It also conveys the point of view of the Italian Association for Complementary Pensions (ASSOPREVIDENZA) and the Public

Company for the Development of the Italian Pension Funds Market (MEFOP). In line with the Federation's mission and mandate, the paper intends to promote a cross-cutting and system-wide approach to the issues of the Green Paper for the Italian financial market as a whole, highlighting the common concerns, trust and vision of the main players in the Italian financial industry.

This publication is intended to engage the Italian financial community, Authorities, stakeholders, academia, policy makers and the public opinion at large in discussing the fundamental issues raised in the Green Paper. The aim is that of promoting a common understanding and perspective for the future, strengthening motivation and drive for reform, feeding constructively the national and European debates on the long-term financing of the European economy. Under this perspective a significant contribution can be found also in the paper by the European Banking Federation (EBF), European Fund and Asset Management Association (EFAMA), European Private Equity and Venture Capital Association (EVCA), Insurance Europe, Italian Association of the Investments Management Industry (ASSOGESTIONI), Italian Banking Association (ABI) and Long Term Investors' Club (LTIC).

We hope that the Green Paper's proposals and specific follow-ups will be implemented before the end of this Commission's mandate, and look forward to continuing dialogue and cooperation with the institutions and all relevant stakeholders on the crucial debate stimulated by the Green Paper.

Rome, October 2013

Fabio Cerchiai

President

1. Italian Banking Insurance and Finance Federation (FeBAF)

on behalf of the Italian Banking Association (ABI), National Association of Insurance Companies (ANIA), Italian Association of Private Equity and Venture Capital (AIFI), Italian Association of the Investment Management Industry (ASSOGESTIONI), Italian Association for Complementary Pensions (ASSOPREVIDENZA), Public Company for the Development of the Italian Pension Funds Market (MEFOP)

This Paper was drafted by a working group, chaired by Prof. Rainer Masera (Università degli Studi Guglielmo Marconi), with the participation of Angela Maria Bracci (ABI), Laura Crescentini (Assoprevidenza), Davide Ferrazzi (ABI), Valentina Lanfranchi (AIFI), Mauro Marè (Mefop), Edoardo Marullo Reedtz (ANIA), Maria Concetta Miranda (FeBAF), Francesca Palermo (FeBAF), Antonella Pisano (Università degli Studi Guglielmo Marconi), Alessandro Rota (Assogestioni), Gianfranco Verzaro (Assoprevidenza).

Introduction

Long-term finance is vital for sustainable growth and for the lasting recovery of the European economy.

The recovery of growth is necessary to reduce unemployment, restore competitiveness and overcome the difficulties of public finances in Member States. A new exit strategy from what has come to be the worst post-war financial and economic crisis should be designed. Financial stability and fiscal consolidation are a condition for sustained and sustainable growth, but in turn the latter is the pre-requisite for long-term financial consolidation.

The urgency of a smart, sustainable and inclusive economic recovery has been advocated in the Europe 2020 strategy and reiterated in the Green Paper. Economic policies founded exclusively on fiscal austerity and consolidation have not been able to reach their objectives, especially when coupled with increasing constraints on capital requirements of banks and insurance companies, and with a highly procyclical accounting framework. There is wide agreement on the need to ensure the sustainability of public finances and to reduce progressively the public debt/GDP ratio. A mix of structural and short-term policies is needed, in order to restore the economic conditions for growth (notably in "peripheral" countries) and to bring down the unemployment rate, especially among young people. The prominence of this issue transcends economic considerations. It addresses fundamental political and social problems.

In this regard, the Commission approach should focus on the need that an effective growth strategy must involve Europe as a whole and, in particular, contribute to untying the knots of the "imperfect monetary union" we in the Eurozone are presently living in. Whereas it is mainly up to the private sector and markets to ensure convergence and sustainability in economic growth, appropriate supporting policies at the European level and at the level of national governments are needed.

Europe has recognized, on many occasions, the essential role of investment for economic recovery. Investment is the basis of a sustainable development process. Reviving investment, therefore, is central to an effective exit strategy and economic recovery. It assumes not playing in defence. It implies responsibility and risk taking. In its absence, there is not any credible prospect for economic recovery. Investment that contributes to increasing total factors productivity (TFP) is especially necessary. This issue is particularly important in Italy, and in other Eurozone countries, also due to the impossibility of making use of the exchange rate tool.

Investments in traditional infrastructures, innovation and knowledge, research and development, energy, the environment, land protection and education, make up a key driver for growth. Public and private investment in physical, human and intangible capital not only supports demand in the short-term, but it also increases productivity and, therefore, sustains the supply side in the medium-long term, by enhancing competitiveness.

In order to promote competition in an advanced manufacturing system and to accompany the necessary passage towards an innovative service economy (involving health, education, an efficient bureaucracy, justice and transport), there need to be significant flows in infrastructure investment, with public-private co-financing.

Saving plays a fundamental role. Without its contribution, there cannot be investment and sustainable development, and neither Europe nor Member States would be able to achieve concretely their aims. The ability to save has proved to be key to the success of the "Made in Italy" and of the Italian economic development model. It also played a role more recently in the Italian economy, protecting it from the disastrous consequences following the 2007-2009 crisis. But the latest crisis has seriously affected households' and firms' ability and propensity to save.

In order to favor long term investment, it is therefore necessary to safeguard and promote saving too, just like it is taking place in the United States and Canada. Long-term investment requires long-term saving.

Question 1: Do you agree with the analysis above regarding the supply and characteristics of long-term financing?

The Green Paper correctly attributes a prominent role to the revitalization of long-term investment for the purpose of relaunching sustainable development.

During the last few years, the financial crisis has been felt in all areas and sectors of the European economy, but it had a particularly negative impact on the ability of the private and the public sector to invest in the medium and long-term. The prolonged recession in Europe, which began in 2008, was in fact characterized by a significant fall in private investment: the difficulties of public finance and the constraints imposed by the Fiscal Compact (which does not distinguish between current expenditure and investment outlays) determined a significant downturn in public investment, notably in peripheral countries.

It is generally recognized that investments capable of generating growth and increasing competitiveness are configurable as long term investments, and ask for consistent financing lasting several years. The financial sector, and the asset management funds, pension funds and insurance in particular, take on a central role in this process, by gathering and channeling resources towards this kind of projects.

The Green Paper has the double objective of elaborating a set of qualitative standards for long-term investment, and to explore new opportunities regarding possible financial tools or architectures.

Numerous high profile studies and contributions on this theme have been developed recently, by research institutions, international organizations and by the European banking and insurance industry itself. Specific mention can be made to:

- Association of Financial Markets in Europe (September 2012), *Financing European Growth: a new model*. The document contains the proceedings of the AFME symposium of 18th September 2012, with the aim of discussing the prospects for the economy and the investments in the next decade.

- Centre for European Policy Studies - European Capital Markets Institute (October 2012), *Supporting Long-Term investing and retirement savings*. The analysis of CEPS shows the results of the works of a task force, with the aim of strengthening the single market for long-term savings and investments in Europe.

- Swiss Re (February 2013), *Strengthening the role of long-term investors*. The report highlights the role of long term investors, especially the institutional ones, as suppliers of risk capital for the real economy and as stabilizers and shock absorbers in financial markets, and the necessity to strengthen their role.

- Financial Stability Board (FSB) (February 2013), *Financial regulatory factors affecting the availability of long-term investment finance*. The analysis highlights the main regulatory reforms that, according to the FSB, could have positive effects on long-term financing (from banks' prudential requirements, OtC derivatives, to accounting rules for different types of institutional investors).

The report argues that these reforms could influence both the incentives for different types of financial institutions to participate in the long-term financial market, and the costs associated with different types of transactions.

- OECD (February 2013), *The role of banks, equity markets and institutional investors in long-term financing for growth and development*. This paper is aimed at identifying the main trends in the transmission channels of long-term financing, by focusing attention on the role of banks, capital markets and institutional investors. Furthermore, it analyses the investment in infrastructures.

- G30 Working Group on Long-term Finance (February 2013), *Long-Term Finance and Economic Growth*. The report aims at quantifying the need for future financing and the obstacles that impede supply potentially undermining economic growth.

- Eurofi (April 2013), *Enhancing the financing of long term projects in Europe*. The work recognises the importance of investment in infrastructure projects and suggests the main ties that need to be undone in Europe to recover growth, dwelling, in particular, on the financial and regulatory context that do not favor long-term investment.

- OECD (May 2013), *High-Level Principles of Long-Term Investment Financing by Institutional Investors*. This draft paper, recently placed in public consultation, has been issued by the Task Force on the topic of long-term finance by institutional investors. The purpose of the Principles is that of addressing regulation and surveillance authorities and stimulating the creation of a political and regulatory framework that encourages institutional investors to provide stable financing to the real economy and to long-term investments.

- Long term Investors Club (LTIC) (May 2013), *Contribution of the Members of the LTI Club on the draft High Level Principles of Long Term Investment Financing of the OECD*. The response to the OECD consultation by LTIC stresses the idea that, before addressing the issue of financing long-term investments, policy makers should focus on the quality of these investments. In this context, the role of the multilateral development banks, other public entities, as well as public long term institutions like CDC, KfW and CDP has been emphasized. They should play a key role in the evaluation of the quality of the investment, and in their monitoring throughout the cycle.

On the whole, we endorse the analysis of the Green Paper and support its conclusion. However, we wish to draw attention to three main aspects that deserve in our view more careful consideration.

1. First, the concept and the different characteristics of long-term investment, and therefore, infrastructure, would need to be further clarified. This definition, in fact, is key to the identification of investments, to which public resources and private savings should be directed.
2. Second, the definition of infrastructure itself needs to be better explained, with reference to public and private capital.
3. Third, the link between public investment and the effective accumulation of tangible and intangible productive capital should be further analyzed. This is an issue that needs to be better explained in the Commission document, and that takes on fundamental importance in many countries, notably in Italy. One needs therefore, to focus more on the quality and the efficiency of investment in infrastructures.

A few remarks on these three issues can be found in the following pages of this paper.

Lastly, the financing of long-term investment needs to be focused upon. In principle, long-term investment should be mainly supported by long-term financing, for two fundamental reasons: for its nature, long-term financing has a lower tendency to procyclicality compared to the short-term one, and thus is best suited

to support expansionary policies during a crisis. Furthermore, it significantly contributes to stabilizing the financial system, by avoiding excessive transformation of maturities1.

Question 2: Do you have a view on the most appropriate definition of long-term financing?

We endorse the most common definition of long-term (LT) financial investment as “patient” capital. Such a definition allows investors to access illiquidity premia (in particular from investment in assets such as infrastructure, real estate and venture capital), lowers turnover and its related costs, and avoids pro-cyclicality. Ultimately, long-term investment strategies, all else being equal, improve net investment returns, strengthen financial stability, and foster economic growth [Severinson and Yermo, 2012]. More specifically, LT finance should refer to maturity over 5 years, including assets that have no specified maturity (e.g. equities).

The Green Paper defines, in broad terms, financing long-term investments or long-term financing as «the process by which the financial system provides the funding to pay for investments that stretch over an extended time period. Investors engaged in long-term financing are generally expected to hold onto the assets for a long time and are less concerned about interim changes in asset prices and are focused instead on long-term income growth and/or capital appreciation».

It correctly links long-term financing to long-term investment, on the basis of its features, and usefully underscores the need to support investment in productive capital, as this investment boosts innovation and competitiveness, and therefore plays a pivotal role in support of a smart, sustainable and inclusive growth of the European economy.

The Green Paper, in particular, considers “long-term” investments those that participate in the formation of long-lived capital, covering tangible assets (such energy, transport and communication infrastructures, industrial and service facilities, housing, climate change and eco-innovation technologies) and intangible assets (such as education, research and development), which are capable of boosting innovation and competitiveness. Long-term investments can be measured by infrastructure expenditure, i.e. the expenditure for the formation of long-lived capital that supports the production capacity of an economic system. Tab 1 and Fig 1 depict the “enlarged” definition of infrastructure proposed in this document.

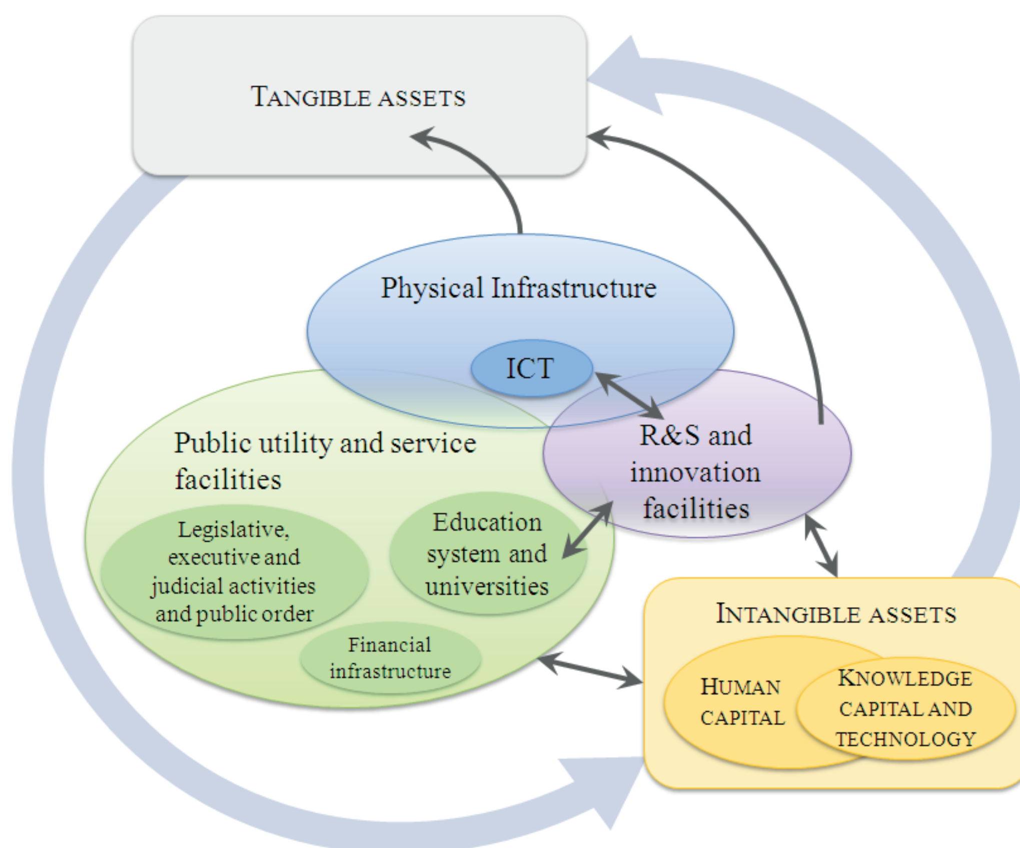
1 See Group of Thirty (2013).

Tab. 1 - The infrastructure system, broadly defined

A.	**Physical infrastructure**	- Transport networks (roads, railways, airports, ports and inland waterways) - Energy networks and infrastructures (electricity, gas, oil) - Renewable energy and *smart grids* - *ICT capital* - Aqueducts and water mains - Networks for integrated waste management - Land protection infrastructure - Urban infrastructure
B.	**Research & development and innovation facilities**	- Knowledge capital and technology - Laboratories and research facilities - Scientific and technological parks - Patents, trademarks and copyrights - Software - Organisational methods
C.	**Public utility and service facilities**	- Legislative, executive and judicial activities (*trias politica*) and public order - Education system and universities - Healthcare system - Protection and management systems for environmental, cultural, artistic and historical resources (including *green infrastructure*) - Civil defense network - National defense network - Financial infrastructures

Source: Masera (2012)

Fig. 1 - The infrastructure system: tangible and intangible assets



Source: Masera (2012)

In defining long-term investment, two factors seem to be decisive: (i) the ability of the different types of investment of contributing to the productivity of a system, and (ii) the need for public-private co-financing.

First, a distinction should be made among the various types of infrastructure spending. In particular, it must be taken into account the different impact that different types of investment have on growth and competiveness. Infrastructure expenditure may directly affect technological change and, consequently, total factor productivity. Or it may raise GDP by increasing public and private fixed capital.

Regrettably, no differentiation along similar lines is made in the document of the Commission. Viceversa, we believe that such a distinction is very useful in order to identify priorities in public spending, also taking into account the budget difficulties of many European countries and the limited resources available in the private sector. It must be stressed that productivity growth is linked to the virtuous interaction of several factors, such as education, knowledge capital, research and development, and basic research [Visco, 2009].

It must be also highlighted that infrastructure cannot be limited to public capital. It also includes co-financed projects (PPP) and privately financed projects, supported by tax/legislative measures or subsidies from the public sector. A particularly significant example of this combination is represented by retrofitting, i.e. the energy-saving requalification of existing buildings (mainly private, but also public). The European Commission estimated that the overall savings coming from the implementation of energy saving measures (in line with the European 2020 targets) would amount to about €50 billion a year. Different studies have come to the same conclusions: they highlighted that suitable combinations of private and public intervention generate very high benefits and release globally considerable economic resources. A broad definition of infrastructure requires the adoption of a systemic and synergic approach between public institutions and private agents to realize projects that, for their characteristics, cannot be realistically entrusted solely to public funding or to private funding.

As observed above, the Green Paper equally refers to long-term financing and the financing of long-term investments, by considering them synonymous. However, the relationship between the two variables is inherently desirable, but not at all automatic. Not all forms of capital accumulation can be considered a long-term investment. It depends on their ability to contribute to productivity growth.

Therefore, the link between medium and long-term financing, and productive investment, must not be considered excessively binding when resources are collected on financial markets, where this relationship is not always so stringent. As an example, by taking the above-mentioned approach, one could hypothetically conclude that an IPO is considered as an operation of long-term financing only if the financial resources are earmarked to specific productive investments for the creation of long-term instrumental goods, and not to any acquisition operation or, for instance, to the improvement of the internal reporting system of the company.

With its definition the Green Paper seems to play down the role of long-term financial investment by mixing the point of view of the economy with that of the end investors. Indeed it is well-known that from the point of view of the latter, a long-term commitment to remain invested in a given financial portfolio is by far the most common way through which long-lived productive capital goods are financed.

In order to avoid a possible misunderstanding on this point, we believe that the emphasis the Green Paper puts on the definition of long-term financing should be adjusted accordingly. For instance a clear distinction could be made between the economy, which is in strong need of long-lived productive capital, and investors, who need the best financial instruments and incentives to channel their savings towards this end.

Question 3: Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

The current long-term recessionary phase in Europe is no doubt influenced by the fiscal austerity measures and by the simultaneous tightening of regulatory requirements on banks and other financial institutions. They represent two composition fallacies.

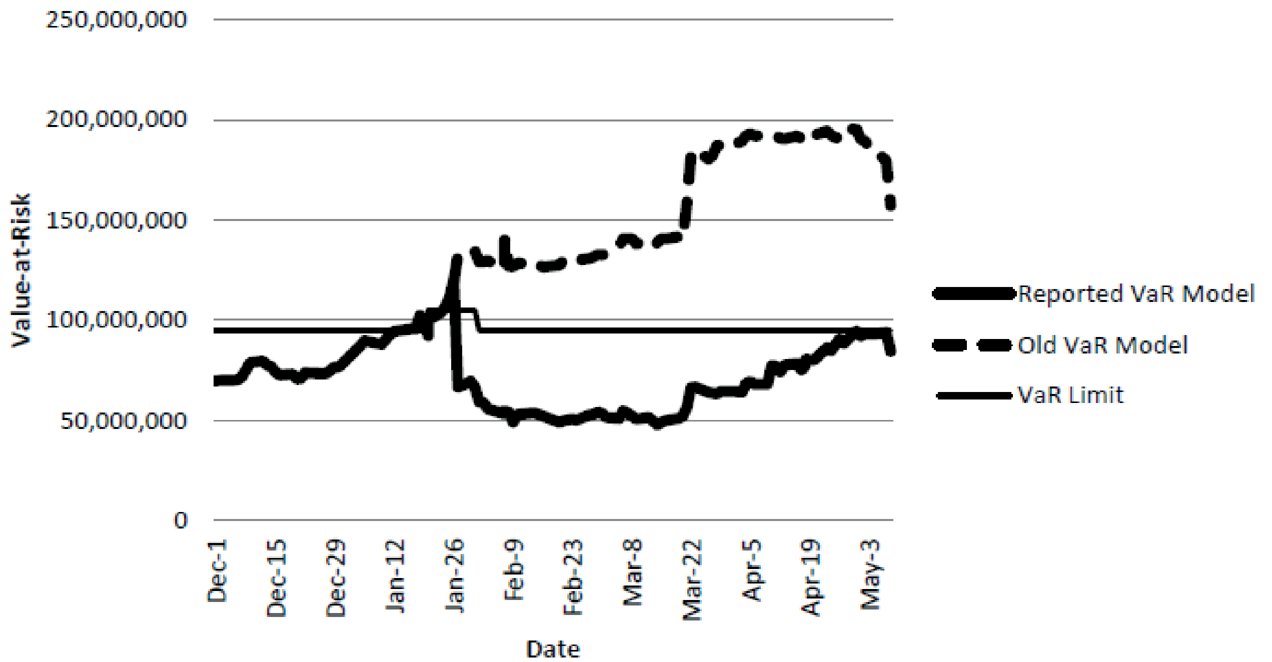
Capital requirements are a cornerstone of financial regulation. They produce social benefits by reducing moral hazard and the cost of bank failures, which would otherwise fall on taxpayers. But, at the same time, excessive capital requirements on banks in a recessionary phase reduce their ability to create credit and liquidity, and to perform the socially important function of maturity transformation.

A trade-off, therefore, is at play here: micro and macro prudential considerations should weigh appropriately in shaping the desirable trade-off, which clearly also depends on cyclical factors. Risk capital requirements are inherently procyclical. The procyclicality is enhanced by the interaction of capital and fair value accounting, which is often – incorrectly - interpreted as mark-to-market accounting.

The use of VaR approaches in CAD IV inherently increases the procyclicality of the system and makes it difficult for banks to extend long-term finance. These problems are heightened because VaR models are based on the assumption of exogenous risk. Instead, endogenous risk may be relevant (shocks to the system may be amplified by the system itself [Danielsson and Shin, 2003]). The Basel approach leads all banks to react in the same way to financial shocks, thereby amplifying financial instability.

Additionally, VaR models can be applied by highly sophisticated banks, as witnessed for instance by the case of JPMorgan (see Fig. 2).

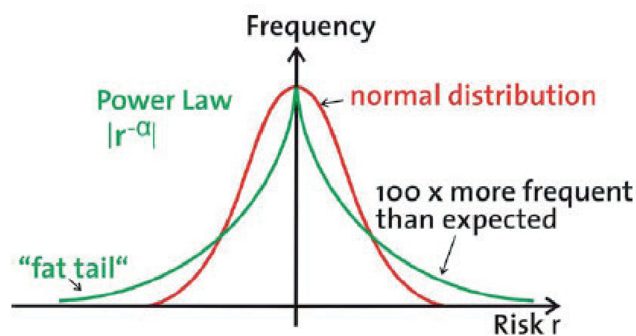
Fig. 2 - Gaming the rules: JPMorgan Chase. Derivatives and VaR Models (10Q VaR)



The change in VaR methodology effectively masked the significant changes in the risk portfolio. US Senate Permanent Committee on investigations (March 15, 2013).

Finally, the European banking and sovereign bond networks are strongly intertwined, and are thus subject to possible sudden shifts from normal distributions to power distributions.

Fig. 3 - Power laws and heavy-tail distributions



Source: Helbing (2010)

The considerations above are also highly dependent on institutional factors. Europe is characterized by a very high relative importance of banks (and insurance) compared to the US, where credit markets and the shadow banking system perform a key role, as exemplified by the following tables and figures.

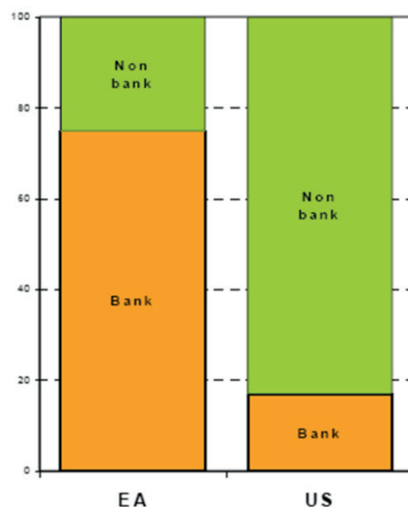
Tab. 2 - Size of EU, US and Japanese banking sectors (2010)

	EU	USA	Japan
Total bank sector assets (€ trillion)	42.9	8.6	7.1
Total bank sector assets/GDP	349%	78%	174%
Top 10 bank assets (€ trillion)	15.0	4.8	3.7
Top 10 bank assets/GDP	122%	44%	91%

Notes: Top 6 banks for Japan.

Source: Liikanen Report (2012)

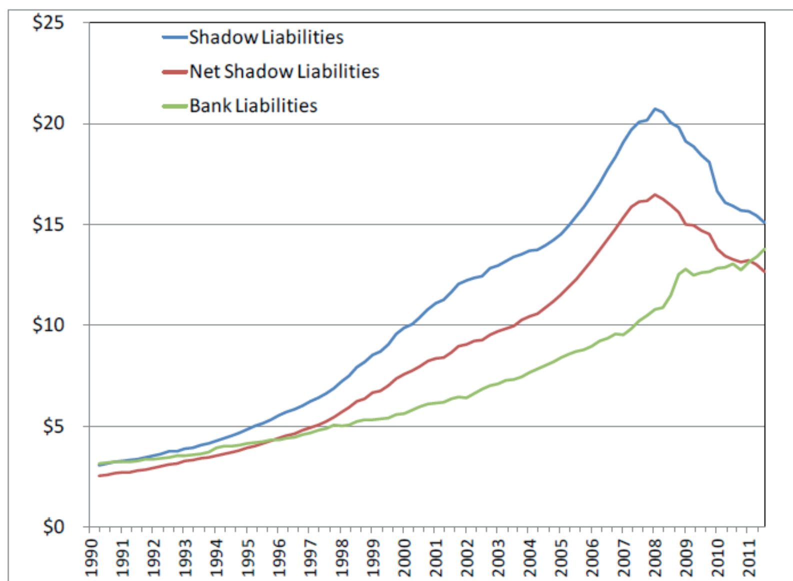
Fig. 4 - Funding of non-financial corporations in the Euro area and the United States



Note: EA stands for the euro area.

Source: Cour-Thimann and Winkl (2013)

Fig. 5 - Shadow bank liabilities vs. Traditional bank liabilities, $ trillion



Source: Pozsar *et al.* (2012)

It is, therefore, evident that the tightening of capital requirements and bank deleveraging have much more significant implications for the European economy compared to the US.

Taking into account the relative size of banking flows and the resilience of bond markets and of shadow intermediation, restrictive capital requirements may have an adverse short-term impact on the real economy potentially three or four times higher in the EU than in the US. This helps explain why the long-term investment contraction has been especially strong in Europe compared to the US.

In addition, without a properly functioning banking union, a vicious negative loop between bank and sovereign credit has manifested itself. Peripheral countries are especially affected also because of the very high importance of SMEs, which are heavily influenced by bank deleveraging.

In any event, we assume that, in Europe, the banking sector would continue to play a fundamental role in financing long-term investment. Particularly in Italy, the banking sector is already operating in a context characterized by growing constraints set by prudential reforms to long-term financing, and will continue to play a key role in supporting the real economy, not only through the traditional activity of savings and the provision of funding, but also through enhancing their efforts to enable the direct access of companies to equity and bond markets, as well as the investment in risk capital of unlisted enterprises.

In many European countries the banking sector plays a central role in the financial product distribution system: any new way of channelling savings from retail investors to long-term projects will probably heavily rely on banks, albeit under a different framework (intermediation rather than own account).

In addition, the expertise banks have acquired in the evaluation of the creditworthiness of long-term projects will likely be important, also for the development of new non-bank financing vehicles.

Question 4: How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could

financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?

The quality of investment determines its efficiency and effectiveness, and makes it more attractive to the private sector. It is therefore fundamental to carefully evaluate the relationship between public investment and effective productive (tangible and intangible) capital accumulation. The great challenge in economic analysis, in empirical research and in economic policy itself is in identifying good proxy variables for public capital adjusted for efficiency. It must be noted that public infrastructure spending, as it is registered under the current accounting procedures does not fully translate itself into productive capital assets. Many studies by academics and researchers in international financial institutions, and by the Banca d'Italia for the Italian economy, show the relevance of these problems2.

Public capital accumulation is justified by and requires net positive externalities. It must be characterized by a higher economic rate of return, than the financial one. But the passage from public investment to capital accumulation with high social returns is far from being automatic. Very often, corruption, waste, inefficiencies, deficiencies in the operation of the so-called trias politica (legislative, executive and judicial power) destroy or distort the link between public spending on investment and the accumulation of productive (tangible and human) capital. Also for these reasons, it is not easy to obtain empirical evidence of the fact that the gaps in public infrastructures constrain or reduce the prospects of sustainable growth.

Quality and efficiency in spending require constant monitoring in the quality and efficiency of financed projects. If rigorous and effective mechanisms of selection, construction, management and financing of infrastructures are not set in place, investment does not translate into capital accumulation [Masera, 2012].

Infrastructure policies in Europe should be revised, (i) by intervening on planning, financing and management methods and procedures, and (ii) by entrusting the monitoring to an independent authority with high technical skills, not subject to political influence, which may enforce quality control on projects, based for instance on the model of the American Infrastructure Bank or the Australian Infrastructure. The institution of a European authority would significantly limit the instability and uncertainty of rules, and thus reduce the regulatory and administrative risk of the investment projects. As happened in other sectors, it could be useful to define common methods and procedures for developing infrastructure projects, that would be applicable to all Member States. Transparent criteria of selection should be provided to identify and support concrete opportunities of co-investments, especially for large scale projects.

In Europe, this task could be undertaken by the EIB. Through its significant operational experience, the Bank could ensure an effective monitoring of the efficiency of public investment, and press for "the investment in the investment process". It could provide an ex ante evaluation of the proposed projects and select them on the basis of an assessment of their technical feasibility and economic/financial returns on investment. It could also ensure an ex post evaluation.

The role of the EIB in cooperation with national authorities should also be strengthened in relation to the need to provide guarantees to the market, to protect operators against certain risk types in projects. This would create an incentive for a greater involvement of insurance companies and other institutional investors.

2 See for example Prichett (2000), Gupta et al. (2011). Dabla-Norris et al. (2011), Arslnap et al. (2011), Balassone (2011) and Banca d'Italia (2012). The issue is particularly relevant in Italy. In this regard, it is useful to remember that, according to the OECD, between 1970 and 2008, the expenditure on transport investments and energy in Italy was equal to 3,2% of GDP, lower than the average OECD data (3,7%), but in line with that of Spain (3,3%) and higher that France (2,5%) and Germany (2,9%). Yet still, the Global Competitiveness Report (2012–2013), elaborated by the World Economic Forum, places Italy in 28th place (in a classification of 144 countries) for competitiveness of the infrastructure system, with a considerable distance from Germany (third place), France (fourth) and Spain (tenth). As Banca d'Italia in the above mentioned studies show, with reference to the measures of public capital in Italy based on reported investments, the accounting practices are misleading, in that only a fraction of expenditure is translated into capital value. This contributes to explaining why measures based on financial flows would show that public capital in Italy is basically in line with that of the main other European countries. Viceversa, if we use measures of physical equipment, Italy appears to be in a worse situation compared with the main European countries. The gap increases even more when the level of use of infrastructures is taken into account, and especially of the quality of the services given. Under this profile, the indexes within the Mezzogiorno (South Italy) appear to be particularly low.

Furthermore, multilateral development banks should widen – in a coordinated way – the plafond funding made available by domestic banks in order to finance businesses. This funding should have a long-term maturity. The access to the plafond should be simplified in order to promote the channeling of resources to the entrepreneurial system.

The operation of the multilateral development banks could also be oriented to create an incentive for the development of financial debt tools directly issued by enterprises through the release of specific guarantees in favor of institutional investors.

Lastly, specific initiatives should be promoted through coordination of national and local authorities for: the improvement and the full exploitation of the financial possibilities offered by the EU Structural Funds; the improvement in the access to finance of SMEs; the support for public and private infrastructure investment; and the support of policies favoring youth employment.

Question 5: Are there other public policy tools and frameworks that can support the financing of long-term investment?

Well functioning institutions and effective compliance with the legal and regulatory frameworks are an essential pre-condition for public and private investment policies. Specific consideration should be given to ensure the timeliness, essentiality and the certainty of the rules and the relative sanction mechanisms. A clear regulatory framework is required for the stability and continuity of the regulatory framework, especially in relation to incentives and investment subsidies (direct and indirect). This aspect is particularly critical in Italy, where not infrequently rules have been modified during the operational phase of a project, thereby determining conditions of uncertainty in investors and operators, fuelling litigations, delaying the completion of the works, and thus creating a disincentive to the investment3.

Rules must be coherent and harmonized across the different sectors (competing with one another in attracting private capital). Furthermore procedures must be transparent to promote effective decision-making processes in adequate times. Simplified procedures could be particularly useful. A fast track model for smaller projects (with less than €5 million of funding), which today represent about 80% of projects, would greatly facilitate the realization of public works.

Attention should also be placed on the development of adequate technical skills, notably for Public Administration officials, and on the critical review of the tender and procurement rules and practices.

Finally, a wider vision and a comprehensive approach to the development strategy should be adopted. Selection should be based not only on a single work or a single type of investment, but also, and more importantly on the infrastructural system as a whole.

The importance of an "effective" accumulation of public productive capital, as highlighted above, should be recognized at the level of the European economic governance. This also refers to the rigid budget rules introduced by the Fiscal Compact, which does not distinguish between current public expenditure and investment spending, and which applies to both of them the same accounting treatment. Criticism has been made, notably by the IMF and the last G8 meeting, to the current "excesses" in terms of timing, frontloading and generalization of fiscal austerity in all countries. Those excesses have been considered counterproductive for economic growth and fiscal consolidation.

Current public expenditure, as a component of aggregate demand, may help to raise the GDP level, but it could have negative effects in the medium term. Instead, infrastructure expenditure - if efficient – would contribute to productive capital stock formation and determine a lasting increase in aggregate production.

As already indicated, in the field of investment expenditure, a fundamental role is played by the financing of research and development, innovation and knowledge capital. They belong to productive capital and,

3 In Italy, in particular, the majority of fund resources invested in *brownfield* works, i.e. to companies which manage works already constructed and active or even in shares of listed companies or privatizations of management infrastructure companies: greenfield investments represent a minority.

thus, positively impact on total factor productivity, by increasing GDP growth and the competitiveness of the economic system.

We fully share the view that public finances in Europe must remain or become sustainable, but - in order to revitalize the European economy through investment in productive capital - we believe that infrastructure expenditures should have a different treatment in the Fiscal Compact.

In particular, considering the present state of the economic cycle in Europe, it would appear to be particularly necessary and timely in the next three years, to take out the investment expenditures in the above mentioned sectors from the constraints of the Fiscal Compact. These expenditures could be co-financed by the EIB, also through the recent increase in capital. The EIB co-financing would contribute in a decisive manner to the appropriate monitoring of quality, efficiency and the profitability of public/private investments, as indicated in the comment to question no. 4.

The prolonged and very high youth unemployment rate corrodes and destroys human capital, and thereby seriously affects the competitiveness of the economy. Therefore also expenditures for the lasting recovery of youth employment should temporarily be taken out of the constraints of the Fiscal Compact. Reducing youth unemployment, also through the revival of investment, is the most fundamental and urgent challenge for Europe.

Furthermore, in order to support investment in infrastructures, a broader diffusion and adoption – also through adequate fiscal incentives – of project and corporate bonds is necessary4.

In addition, technical skills in the field of project financing need to be strengthened at the national level, through an effective support to local authorities, that are often unprepared in launching and monitoring project financing initiatives.

A fundamental incentive to the participation of institutional investors would also derive from the implementation of public guarantee mechanisms. They are already provided at the European level, but should be better developed and promoted. An example is the Loan Guarantee Instrument for Trans-European Transport (LGTT) provided by the EIB for projects within the TransEuropean transport network, which supports market operators in facing the initial risks of a project, on the basis of its long-term financial feasibility. Along these lines, the Euro Project Bonds have been introduced aiming, in particular, at financing European infrastructure projects, which cannot be realized exclusively on the basis of market conditions, but are strategically important for Europe. In regards to this, the initiative of the UK government should be pointed at: it has introduced – within the National Infrastructure Plan 2011 – a scheme of public guarantees to support the main infrastructure projects, which may be incurred in difficult financing conditions.

Finally, the evolution of the current macroeconomic context, characterized by low interest rates, should also be taken into account. Certainly, low rates benefit the economy, by encouraging long-term investments. But, if such low levels are maintained for a long period, they may also have negative effects, by reducing the propensity to save and creating distortions in the allocation of savings. Besides, in the presence of very low interest rates, consumers must save much more.

Question 6: To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

The Green Paper recognizes the fundamental role of institutional investors in long-term investment, also on the basis of their specific functions.

Insurance companies are typically considered “natural” long-term investors, in relation to the nature of the liabilities they hold. They carry out “matching” policies within the usual practices of asset-liability management, in line with their business model. Today, in Europe, insurers represent the most important transmission channel for long-term investors, with assets equal to about 50% of the GDP within the Euro Area

4 See, for instance, Gilibert (2012) and OECD (2013a).

and managed stocks of around 9 trillion Euros.

The role of investors and the investment strategies of insurance companies generate important benefits both for people insured and for the economy in general. These institutions can offer an important contribution to addressing the funding gap problem, which characterizes the current European economic situation.

Long-term investment strategies bring about benefits for savers, because they give access to a wider choice of investment opportunities, often with better performances compared to those obtained by single individuals. A greater level of diversification and the use of more illiquid securities allow for high returns, lower transaction costs and reduce short term volatility. The combination of these benefits allows the insurers to offer products of long-term saving and retirement at acceptable costs, both for insured customers and for those who supply capital to cover the risk. Furthermore, they represent a valid support for the public pension system, thanks to their ability to offer complementary guarantees linked to longevity (among which long-term care policies).

Generally, as previously discussed, benefits deriving from these strategies reside mainly in the stabilizing role that they can play. Insurance companies are naturally attracted by long-term investment horizons, given the nature of their business. They do not have the exploitation of short-term volatility or the returns of financial products as their primary goal. Rather, they aim at the maintenance of securities up to their maturity, in view of the need of having sufficient resources available, in order to maintain commitments towards people insured. In this way, they reduce the pressures of procyclicality and give stability to financial markets.

Insurance companies invest in a large spectrum of security types, according to the duration and the type of securities that they hold (generally illiquid) and the type of product offered. Normally, they invest in bonds issued by governments, corporate and covered bonds (about 60%) and in equity (15%), but also undertake securitization operations, direct loans to the SMEs, and investment in infrastructures, mortgages, real estate market, private equity and venture capital, based on the desired risk-return profile.

In order to support the important role of insurance companies, some changes in the regulatory framework appear to be necessary, as indicated, for example, by Thomas Hess, Chief Economist Swiss Re [cited by Wehinger (2011)]:

«Fixing regulatory bugs would favor long-term investments. Many observers are surprised how little long-term investment risk insurers assume. For insiders, this is hardly a mystery. The reason often boils down to regulation: when pro-cyclical elements of regulation “force” insurers to sell risky assets at the worst possible moment, one should not wonder why insurers avoid such risky assets. (Similar issues can arise in relation to accounting standards.) Also, state-enforced, asymmetric profit-participating schemes (life policy holders share in profits but losses have to be absorbed by shareholder capital) are clearly disincentivising insurers to take investment risk. Another problem is the double taxation of equity capital, which disincentivises the holding of equity capital. This reduces risk appetite in general, and for long-term investments, in particular».

Alongside the insurance companies and pension funds, the Green Paper identifies the private equity funds as potential suppliers of long-term capital.

At the European level[5], insurance companies and pension funds are considered the main sources of collection for private equity funds, with 34% of the total contribution, shared respectively as follows: 8% from insurance companies and 26% from pension funds[6].

The private equity and venture capital market must return, therefore, to connect itself with its main stakeholders. By taking other European realities as an example, as the data shown above indicate, it is even more opportune now, especially for Italian funds, to get closer to the investors in long-term capital,

5 Source AIFI, PwC, AFIC, EVCA data from 2007-2011.

6 Compared to what happened in Europe, the Italian statistics on the collection of the sector show the pension funds in fifth place in terms of amount invested (9%).

such as the pension funds and insurance companies, which for the investment cycle are more adaptable to fundraising of private equity funds, giving the latter, at the same time, the intermediary role of risk capital towards Italian companies.

Furthermore, in a market stage in which the demand for finance by SMEs are not fully satisfied by the banking system, the asset management industry can take on an important role by bringing together companies and investors through investment solutions that allow for the direct access by SMEs to the bond market, an asset class in which it is unlikely that individual investors can directly invest with adequate diversification. In essence, it is necessary to support – on the basis of what has already been carried out in some European countries (e.g. in France) – the development of investment funds, mainly closed and specialized in investment in debt securities of medium-sized enterprises, capable of correctly selecting companies to be financed and adopting diversification polices of the portfolio and risk management and the limited liquidity. Having this purpose in mind, a simplification of the procedure authorization with the competent authorities should be provided, with the aim of allowing quicker growth and commercialization of these vehicles, as well as the possibility for financial institutions of the public sector to take on minority stakes of these investment vehicles also.

Among the institutional investors, a relevant role for the expansion of financing for productive investment could be played by the supplementary pension funds. Currently in Italy, people enrolled in pension funds only represent around 25% of the total number of employees and manage a wealth of over €104 billion, to which about €50 billion of Professional social security funds may be added.

There are no products specifically targeted at pension funds. The latter which are therefore obliged to make use of financial tools available to all economic operators, taking on risks that are not consistent with the characteristics of social security investments, which, by definition, must refer to the long period. Investment by pension funds should also usefully link with initiatives of the central or peripheral Public Administration, aimed at building infrastructure, public utility and energy facilities or to the capitalization of small and medium sized enterprises, thereby providing a positive stimulus to employment and economic growth.

Question 7: How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?

The experience of the capital standards in relation to banks suggests caution in the introduction of stringent and strong procyclical prudential requirements. With regards to insurance companies, it must be underlined that the Solvency II regime is not currently foreseen in the US. Solvency II focuses on a market-based valuation of both assets and liabilities (the accounting principle) and on a risk sensitive capital standard, which is effectively based on a VaR approach (one-year 99.5%).

As has been indicated by many, and notably by OECD [Severinson and Yermo, 2012], this approach has many drawbacks. For instance, life products are designed and regulated around the principles of book investment yield and cost accounting. The shift to the mark-to-market regulatory balance sheet would be inconsistent with the way these products work. This will especially affect the LTG package.

The “one-size-fits-all” approach does not address the current specific problems of insurance operators in the various countries. In Germany, the major problem lies in long-term guarantees with extremely low long duration yields. In peripheral countries with high sovereign spreads, the problem lies mainly in the possible volatility of long-term government bonds, even if they are held to maturity.

More generally, a negative impact on long-term investment inevitably arises due to the disincentive to assets held as a match for long-term liabilities. Here again, the very different investment scenario in the various countries creates complex adjustment problems. To summarize, in Italy government bonds traditionally play a significant role as long-term investments. In France, equity investments are especially important. In Scandinavian countries, infrastructure funds play an important role, while in the UK and Spain corporate

bonds are preferred.

The European Commission is facing a very difficult task by including in the Solvency II (and CAD IV) framework the concern of providing long-term finance to support the recovery in Europe. By definition, Solvency and VaR increase the procyclical effects in financial markets. As argued by the OECD, but also by ECB/BIS [Praet, 2011], Solvency II would lead to homogenous investment strategies across the European insurance sector. Insurers' investment strategies «may become more synchronised under a common regulatory framework. Where they used to exhibit contrarian or stabilising behaviour, they may henceforth move in the same direction as markets and the economy, leading to procyclical effects».

The new rules have the aim of strengthening the security and stability of financial institutions. But they bring about inevitable increases in the cost of financing and non-negligible effects on investment decisions. The new regulatory framework on capital requirements for insurance companies (Solvency II) and on collateral for OtC derivatives (EMIR) could, if not correctly calibrated, discourage investment from insurance companies in some asset classes, and notably in some types of long-term investments.

The proposed rules do to not take into account the aforementioned tendency of the insurer to hold securities to maturity, which makes them less exposed to market risk compared to buy and sell strategies.

With reference to insurance companies, assets discounted at market rates and liabilities at risk free rate create the risk of introducing "artificial volatility" in the balance sheet. In turn, this creates the need to hold buffers of capital not proportional to the real level of risk undertaken, especially in periods of negative market conditions.

A second important threat deriving from the introduction of poorly calibrated regulations is the one connected with the materializing of a strong disincentive to maturity transformation. The crisis has clearly highlighted the risks associated with an excessive use of maturity lengthening. Nevertheless, we need to consider that similar practices, made more onerous from a regulatory point of view, on the one hand contribute to shift the risk on the investors by increasing the cost for the insured and, on the other, prevent beneficial maturity transformation.

At European level, the current review process of the IORP (Institutions for Occupational Retirement Provision) directive (IORP II) has raised eyebrows, clearly expressed also by the private equity industry; the same approach has been adopted as in the Solvency II Directive, which is highly penalizing, notably because it discourages investment in the asset class of private equity.

The private equity and venture capital sector is now affected by the process of community harmonization in view of the implementation in the Member States of the Alternative Investment Fund Managers Directive and by the forthcoming entry into force of the European regulation for venture capital funds.

The change in national dynamics and the creation of a single European market must rely on a harmonized and sound regulatory and surveillance framework. As highlighted, an important factor which drives the choice of asset classes and the temporal horizon of investments is represented by the regulatory and macroeconomic context.

Similarly, with regard to pension funds, support for long-term financing cannot determine negative effects on sound and prudent management. The aim of the complementary funds is precisely that of providing a complementary pension. In order to fulfill this aim, they must adopt investment strategies that enhance and, at the same time, protect the capital of underwriters.

It should be considered not only possible, but also desirable to pursue the aims of (i) voluntarily channeling part of the resources from pension funds towards the financing and recapitalization of SMEs, and (ii) favoring investment for sustainable development, as well as public infrastructures projects, always ensuring adequate and stable financial returns. This would allow to pursue the twin objectives of ensuring an adequate return on retirement savings and contribute to economic development.

In this respect, it is useful to recall the fundamental principles of the Italian legislation (D.M. 703/96),

which sets out the management criteria to comply with: “the pension fund works with a view to ensuring that its financial resources are managed in a sound and prudent way, having regard to the objectives of diversification of investments; efficient management of the portfolio, diversification of risks, including counterparty risk; containment of transaction costs and maximization of net returns”.

In conclusion, we endorse the OECD analysis [Wehinger, 2011], according to which the regulatory setting often provides unfavourable incentives for long-term investment, which must be corrected.

«In particular, accounting rules that are appropriate for investment banks and trading activities are not very relevant, promote short-termism and therefore sometimes penalise long-term investors. The new Basel III capital and liquidity requirements will probably discourage long-term banking and financial initiatives. Moreover, the IASB mark-to-market philosophy is particularly damaging for long-term investments, attributing instant market pricing to assets whose value takes a longer time horizon to ascertain; and the European Solvency II Directive will discourage insurance companies and pension funds from investing in infrastructure assets, not allowing them to properly match long-term liabilities on their balance sheets with long-term assets.

While OECD figures show institutional investors’ assets at USD 65 trillion in 2009, long-term investment of these assets is facing liability and governance constraints, allowing only a small part to be available as long-term capital. But if enough investors with a long-term horizon were active on financial markets, they could act as shock absorbers, as they did in the past. While institutional investors are starting to invest directly in core infrastructure assets and are increasingly becoming familiar with this asset class, it is estimated they are investing only around 2% of their assets, on average, in infrastructure, much below their balance sheet potential for long-term investment, estimated at USD 7 trillion. Equity demand for infrastructure is likely to increase, but if the supply of capital does not follow suit, this may result in an infrastructure “equity crunch”.

Regulatory reforms conducive to long-term investment should involve not only accounting standards and prudential principles, but also: (1) tax incentives; (2) better (sectorial) regulating mechanisms for project financing initiatives; (3) better corporate governance (including compensation) systems; (4) new long-term financial instruments that source from both public and private funds (perhaps drawing from the recent European experience with equity funds, such as Marguerite and InfraMed, and EU project bonds); and (5) credit-enhancing mechanisms to lower the risk and decrease the cost of long-term initiatives in strategic sectors, such as infrastructure, energy and technology».

Question 9: What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?

As explained in the document prepared by ABI and as indicated in previous answers, it would be desirable to support the development of investments in equity of unlisted companies by managers of private equity funds.

In this perspective, and according to the Italian experience, an important contribution has come from the Italian Investment Fund (Fondo Italiano d’Investimento) whose capital was subscribed by important Italian banks and by other financial institutions, including public entities.

Long-term financing by institutional investors should represent a driving force for the development of additional sources of finance, coming from less experienced investors. A relevant example is represented by the segment of finance through online portals in innovative startups, whose regulatory framework is emerging in Italy and should be harmonized at European level.

As far as investment funds are concerned, it is straightforward that closed-end products are the first-best option to provide for long-term financing of the economy. However, taking into account that the bulk of the European fund market is represented by open-end funds, we believe that such products should be specifical-

ly considered in this context as well.

We suggest developing a common EU regulatory framework that moving from the UCITS experience would allow for the creation of funds specifically dedicated to long-term financing. Should this new framework be developed as a new category of product within the existing UCITS Directive or as a separate stand-alone regulation, it shall provide for asset eligibility, redemption and borrowing rules appropriately chosen to best balance the long-term approach of investment policy with the liabilities features of the product.

In particular, the scope of eligible assets should be broadened beyond the current UCITS rules. For instance, long-term funds (LTFs) should be allowed to invest in infrastructure, urban development projects, renewable energies, small and medium-sized enterprises and bank loans.

Redemption rules should be strictly calibrated to the structure of the portfolio. As a general rule a rise in the weight of illiquid or long-oriented investments should be appropriately matched with a consistent reduction of liquidity liabilities of the LTF through the provision of (longer) lock-in periods or restriction to access to early redemption provision, if any.

Finally, explicit albeit limited borrowing powers should be awarded to LTFs in order to gain access to an appropriate level of leverage, but also to be in the position of smoothly managing the liquidity provision.

A specific regulatory framework would increase LTFs visibility and attractiveness. In addition we deem crucial for their success that they are also granted valuable tax benefits targeted to raise the interest of short-term oriented retail investors. Should they eventually decide to trade the liquidity of part of their savings with the participation in the long-term investment of the economy, the cost of the tax breaks would probably be fully repaid in the mid term.

Question 10: Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?

It has already been indicated that prudential reforms, in particular CRD 4 and Solvency II, can have negative effects on the level of cyclicality of investments. General considerations on specific negative features of Solvency II have been already mentioned[7].

The need to review some of the current proposals for CRR and CRD4 cannot but be reiterated. Regulators are conscious of the relevance of the issue of long-term financing, but they have postponed the exam of this issue to the end of 2014.

More specifically, the problem could be addressed by making a downward adjustment of the capital requirements: (i) at least up to maximum amount agreed, laid down as a percentage of the portfolio of each bank; (ii) even if the operations are in the hands of medium and small sized and/or not rated externally operators; (iii) even if the single operations are not of relevant amount (for example, green energy projects).

Question 12: How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?

The need to support equity finance for SMEs has already been highlighted. Specific proposals on the measures that the Commission could introduce in capital markets to provide for this need are well explained in the response by ABI. The main points are reiterated here.

7 See Wehinger (2011).

The principal companies managing markets, also as a result of the changes introduced by new legislation, have promoted “trading venues” (Multilateral Trading Facility) for the negotiation of SMEs’ equity securities, targeted to professional investors and generally characterized by obligations, admission costs and a more contained permanence for the issuers compared to what is foreseen in the regulated markets. Some markets dedicated to the SMEs (e.g. AIM UK, Euronext) already possess the requirements to attract enterprises coming also from other countries. In other markets of a more domestic dimension, the number of investors specialized in this asset class must grow, with specific support for financial institutions coming from the public sector.

Recently, the financial crisis has highlighted the need, especially for SMEs, for diversification of the sources of finance by collecting financial resources through the issue of debt directly in the market. Both the platforms of domestic character to encourage the negotiation of securities issued by enterprises and the markets aimed at issues sold through private unlisted placements (e.g. the German market of Schuldschein) have been developed in Europe in addition to the EMTN market.

The fragmentation at the domestic level of the markets for debt securities of SMEs does not facilitate the provision of financial resources for SMEs. It would, therefore, be useful to encourage, by respecting the appropriate institutional characterization of each country, a harmonized non-regulated European market for bonds issued by SMEs, characterized by harmonized entrance and permanence procedures, as well as by standardized documentation, and by low costs of admission.

Question 13: What are the pros and cons of developing a more harmonized framework for covered bonds? What elements could compose this framework?

As was already indicated under the previous point, it appears desirable to gradually construct a harmonized framework for the “guaranteed” bonds, without creating a “one size fits all” system. It is evident that a greater harmonization in the field of covered bonds would favor the penetration of these tools in international markets, thereby reducing costs of transaction and promoting the liquidity of the market for this asset class.

Question 14: How could the securitization market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system

All in all, albeit useful, developing common standards on covered bonds does not seem to represent the highest priority when it comes to creating an incentive for long term investment. We consider a revitalization of the securitization market to be more urgent, as these instruments play a pivotal role in the maturity transformation strategies of financial institutions.

There are many sub-categories of securitisations, including asset-backed securities (“ABS”), collateralized debt obligations (“CDO”), collateralized loan obligations (“CLO”), etc.

Securitisations have acquired a bad reputation and new issuance has declined dramatically after being blamed, at least in part, for the credit crisis. This reputation is to a large extent unfair and unjustified by the performance of these assets in Europe. For example, according to the April 2012 Fitch Ratings report “Solvency II and securitisation”, at end-July 2007 total losses for AAA tranches in Fitch’s ratings portfolio were estimated to be 6.5% for US residential mortgage backed securities (RMBS). By comparison, European, Middle Eastern and African AAA total losses are estimated at only 0.8%.

Insurers are typical buyers in this asset class. While insurers have currently invested in a range of securitisations (for example, of the 13 companies surveyed, securitisations accounted for around €53 bn), their investments are focused on specific parts of this market, namely: ABS (general term used for bonds or notes backed by a pool of assets); MBS (bonds whose cash flows are backed by mortgage loans).

In addition, and perhaps more importantly, insurers tend to be attracted by senior tranches of assets only enabling them to access some of the additional spread pick-up available on the underlying collateral pool without increasing the riskiness of their investment portfolio.

We fully support any initiative to improve data transparency in order to fight well known issues relating to asymmetric information, both i) at the securitization stage and/or in terms of suboptimal screening activity at loan origination and ii) after securitization, in terms of suboptimal monitoring.

The paper "Securitization is not that evil after all", published by U.Albertazzi, G.Eramo, L.Gambacorta and C.Salleo in 2011, provides a few ideas which seem to be worth investigating:

- originators may choose to securitize loans that have a relatively low content of soft information or loans characterized by better-than average quality;

- originators might retain a high share (much higher than in the past) of the securitized portfolio's risk by keeping the most junior (equity) tranche as a signaling device of its (unobservable) quality or to express a commitment to keep monitoring borrowers. Finally, relying on securitisations on an ongoing basis implies enjoying a flawless reputation; this should represent a natural disincentive to sell off bad parts of the loan portfolio.

Some market commentators are optimistic that the securitisation market will start to grow again. However, as of today, there is less optimism about insurers increasing their allocation to this asset class, because Solvency II is expected to place high capital requirements on these assets. A much "softer" treatment is expected for covered bonds.

Question 16: What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?

The Italian banking system has on many occasions expressed itself in favor of greater fiscal coordination in the European Union, and supported the project of creating a harmonized tax base for European companies (CCCTB). The difficulties in the realization of this project, which did not have any relevant evolution after the initial presentation, must therefore be faced up to, and brought to solution.

Question 17: What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?

Saving is fundamental: without its contribution there cannot be investment nor sustainable growth in the medium-long term, nor is the State capable of achieving its institutional objectives. The conditions that allowed for the miracle of the Italian economy in the post-war period need to be recreated: high rates of savings, private and public investment, international competitiveness, even with the discipline of fixed exchange rates.

Even before considering the case for saving incentives, the EU legislator should ensure an optimal reference framework for the formation and use of savings, by avoiding the introduction of contrasting and distortionary elements. For instance, the preoccupation of insuring benefits for long-term investments appears in contradiction with the proposal for the introduction of a financial transaction tax, which - according to the proposal of the Commission - would also affect operations involving debt securities, both public and private.

The legislation to support long-term savings should therefore:

- favor the detention of long term investment by the saver without regard to the deadline of the issue (thus avoiding the repeat of distinctions similar to those once foreseen in Italy, which penal-

ized the issues of short-term securities compared to medium and long-term ones).

– expect that the benefit operates regardless of the instrument, i.e. independently from the fact that one deals with shares or bonds, mutual funds, insurance policies.

Question 20: To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

Banks have considerable discretion in setting the book value of assets higher than values implicit in stock prices and to limit asset impairment under stress. Market prices and book values differ significantly, especially during a period of financial distress. Excessive discretion may deliver inaccurate accounting information at a time of turmoil, with potential adverse consequences for the allocation of capital in the economy. Market prices (notably price-to-book ratios) should therefore play a primary role in bank supervision as an instrument for Prompt Corrective Actions (PCA): market values have a superior signalling content compared to accounting aggregates in predicting banking system distress during financial crisis [Masera and Mazzoni, 2013].

As of today, insurance companies finalize their individual financial statements following local GAAP principles and their group financial statements following international accounting standards (IFRS 4 for the valuation of insurance contracts, which allows the adoption of local GAAP). Going forward, further implementation of IFRS 4 standards and the introduction IFRS 9 standards (for asset valuation) might introduce elements of artificial volatility in the balance sheet. The new IFRS 4 e IFRS 9 should be designed in order to correctly represent the long term nature of the insurance business avoiding artificial volatility.

Insurers should not be required (but be permitted) to adopt IFRS 9 before the mandatory effective date of IFRS 4. Otherwise it would be put into question the usefulness of financial reporting for users in the period between IFRS 9 and IFRS 4 adoption, as users will experience two major changes in an insurer's financial statements in short succession. A staggered adoption would not result in improved financial reporting for insurers in the period between adoption of IFRS 9 and IFRS 4 due to the fundamental interaction of financial assets and insurance liabilities for insurers.

Question 22: How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?

The recent legislative and regulatory changes show a preference for remuneration criteria which encourage long-term investment. Some of these changes have already been adopted (remuneration guidelines are an example), other are still in the process of being issued. Before new legislative interventions, and avoiding the risk of a hypertrophy, it would be appropriate to let markets react and adapt to the regulatory changes already decided and under way.

Question 26: What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

The lack of a true Banking Union enhances the difficulties of the ECB to spur growth, since low interest rates and very large loans to banks are not properly transmitted to the real economies (and notably to SMEs) in peripheral countries. It would, therefore, be especially important if the ECB could support, through direct acquisitions of securitised SME loans, the credit flows to this vital sector of many European economies.

Generally, the system of co-guarantees in favour of credit granted to infrastructure and SMEs should be developed in a consistent European framework by putting together EC, EIB, EIF, Central National Guarantee System and co-guarantees offered by public and private operators.

In this regard, Italy has a positive experience through the operation of Fondo di garanzia per le PMI (Guarantee Fund for SMEs). The model created for debt finance has been opened also to equity issues.

In addition, it is necessary to promote the use of alternative and complementary financial channels in Europe, also in favor of SMEs. In the short run, the combination of recessionary fiscal policies and stringent capital rules determine a paradox: in the US, large companies, which have easier access to capital markets, have a larger role than in Europe compared to SMEs; in Europe, SMEs have a higher weight and are more dependent on the banking system in their financing. Therefore, the stringent rules in EU need to be revised, by balancing the aim of financial stability with that of sustainable recovery.

With regard to financing of companies and infrastructure projects, Italian insurance industry might have a more active role. But this would require new financial instruments. It is necessary for Italian companies to tap capital markets with the support and help offered by their reference banks. This process would help improve both the financial structure of the enterprise system and the income flows of the banks. The insurance companies therefore support the possibility of buying adequately structured securitized products and covered bonds; they are ready to contribute to the definition of solutions for the construction of specifically dedicated Funds for the investment in SMEs with good growth prospects.

The European Investment Bank Group (EIB Group), consisting of the EIB and the European Investment Fund (EIF), plays an important role in the financing of businesses, innovation and green growth. While the EIB is very active in the funding of later-stage companies and projects, early stage SME financing is undertaken by the EIF, which uses its resources to share risk and catalyse private-sector funds and banks into increasing their investment in high growth and technology driven enterprises. A wide range of financing solutions are being provided and are being further developed based on the following key building blocks: (i) the transformation of grants and subsidies into revolving financial instruments, with future models of public intervention involving a better combination of grants, equity co-investments, loans, guarantees and fiscal incentives; (ii) the structuring of those interventions to reflect the risk profile and the potential financial, social and environmental return; (iii) using public budgets to stimulate growth via private sector investment (the next generation of Public Private Partnerships – PPPs). Examples (all of them in their early stage of development) that further incorporate these building blocks are Project Bonds, risk-sharing instruments for innovation, and intellectual property financing [Pelly and Krämer-Eis, 2011].

With specific regard to the banking sector and the new capital requirements, envisaged in CAD IV, and taking into account the current difficult economic situation, it would be wise to review the current European prudential regulation in terms of equity held by banks in private equity, in order to strengthen the recapitalization of operationally valid companies.

The European directive on capital requirements for exposures in private equity instruments take on great importance for the banks, because they are often among the main subscribers of private equity funds, as well as direct investors in equity of the enterprise sector. A penalizing treatment of these investments makes them less convenient for banks and consequently reduces the financial resources for the creation and development of innovative companies, with a negative impact for the economy.

With regard to the exposures in private equity, both direct and indirect (through specialized funds) the concept of “sufficiently diversified portfolios” is particularly important, because it changes the treatment foreseen by the Basel discipline, based on the assessment of whether the investments are sufficiently diversified. With specific reference to the IRB approach, the weight falls from 370% to 190% with regard to investments made in terms of a sufficiently diversified portfolio. The directive on capital requirements, nevertheless, doesn’t offer a satisfactory definition of this concept. This would instead be necessary, also with a view to avoiding regulatory arbitrage.

The time has come to prepare European legislation that disciplines the provision of capital through online portals (crowdfunding). In the concept of new businesses, the category of innovative start-ups must be included. In this respect, Italy is at the forefront. The aim is to create a framework, also in respect of equity crowdfunding. A EU wide discipline of this phenomenon could give impetus to growth of a European system.

Entrepreneurial initiatives would be stimulated with a view to reaching a critical mass of equity offerings that would generate innate selection and rewarding mechanisms for the best ideas.

Finally, an interesting initiative recently launched in the Italian market can be recalled in this context.

In 2012 Consob, the market watchdog, together with the most prominent finance and industry associations, launched an action plan named "PiùBorsa" consisting of a number of commitments and activities aimed at improving SMEs access to the equity market. In fact, these companies, which represent the bulk and, in many cases, the most innovative tier of the Italian production system, are strongly under-represented in the stock market compared with their role in the economy and still account for only a very small fraction of listed companies.

According to the plan details, education and SME scouting activity will be incremented thanks to a better coordination of current and future initiatives: the Italian Stock Exchange 'Elite' project, the definition of guidelines to make prospectus production and post-IPO rules compliance easier, the launch of partnerships among the associations involved in the plan with the purpose of giving a further boost to the scouting activity of companies potentially interested in tapping the stock market.

Consultancy and assistance in the listing process should be improved by making easier to identify service providers and compare their costs. In addition specific post-IPO assistance should be granted to SMEs accessing the program, including reduction of standard market and regulator fees, red-tape reduction through a single facility, taking care of all formalities connected with listed status, promotion of services associated with on-going trading such as organization of road-shows, production of financial reports (equity research) and assistance for liquidity-providing activity.

Finally a specific plan for promoting SME-related asset management products has been devised: a fund of funds project is being developed aimed at collecting resources from institutional investors (foundations, insurance companies, pension funds, government and regional entities) and at subsequently investing them in funds/vehicles devoted to small caps.

Investment of part of the assets of existing open and closed-end funds in listed or about-to-be-listed SMEs is being encouraged thanks to the efforts of Assogestioni. At the same time an increasing number of management companies are considering the institution of new funds specialized in SME investment as a way of expanding their range of products and give a positive answer to the mounting demand for alternative financing solutions coming from small and medium Italian businesses.

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- Italian Association of the Investment Management Industry (ASSOGESTIONI)
- Italian Banking Association (ABI)

Italian Association of the Investment Management Industry (ASSOGESTIONI)

1] Introduction

Economic recovery and sustainable growth need to be investment-driven. Investment leads to innovations that improve the competitiveness of businesses and markets and hence also to income growth and job creation.

In this context *long-term* investment plays an essential role in contributing to economic progress especially in the fields of infrastructure, urban development, renewable energies, small and medium-sized enterprises and innovation.

Strong increases in public debt and deficit levels imply that today in Europe there is less scope for government spending to provide the desired level of investment, in particular of the long-term type. Therefore there is a strong need to attract an increasing amount of *private* capital to offset the current and future decline in *public* capital availability.

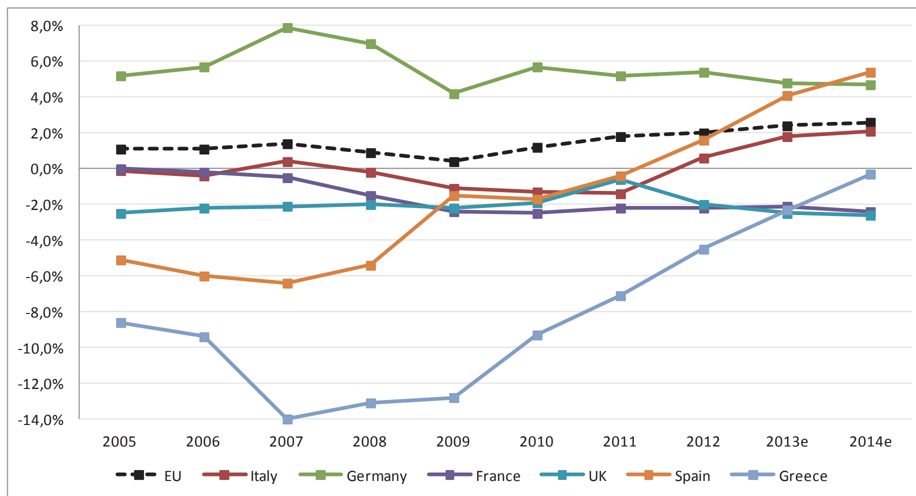
2] The supply of long-term financing and characteristics of long-term investment

Question #1: *Do you agree with the analysis out above regarding the supply and characteristics of long-term financing?*

At the European level the recent economic crisis resulted in a downward trend of both investment and saving rates, now at *similar levels* slightly below 20%. However the *aggregate* data do not reflect a number of differences among countries and in maturity structure, the latter being even more crucial to the current debate and in needs of addressing as a matter of urgency.

On the basis of Eurostat data, strong differences between countries can be noted. Germany has always been a ‘net saver’ as opposed to countries such as Spain or Greece. As a consequence of the current crisis, the latter have experienced a long and painful period of investment shrinkage that will likely represent a major setback for the future recovery of their economy (Figure 1).

Figure 1: Difference between savings and investments as a percentage of GDP. Source: Eurostat.

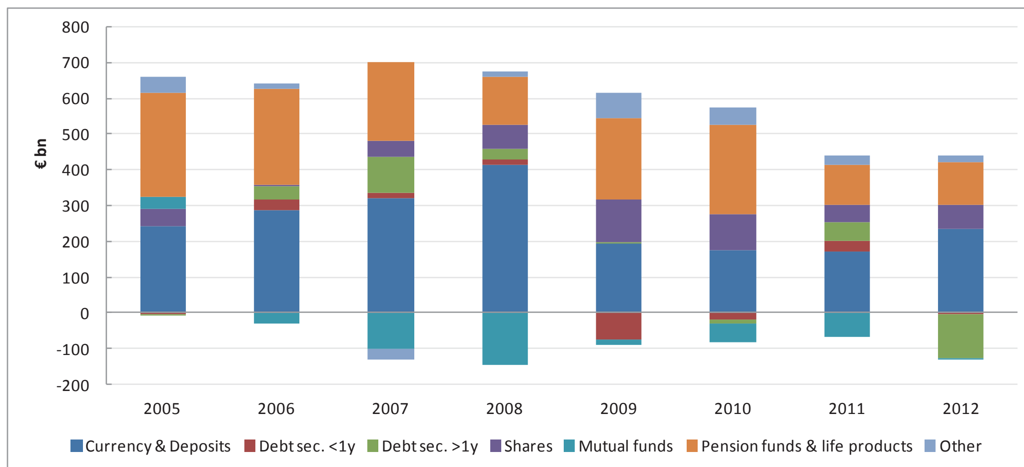


Under the perspective of maturity profile, given the positive externalities of long-term oriented investments, governments have always played a key role in their financing, using taxation and debt issuance to collect the resources needed.

Unfortunately, the strong efforts that many European countries are making in order to tackle high public debt and negative deficits will likely result in less (long-term) government spending for quite a long time. That will in turn increase the negative gap between the actual and the optimal level of long-term investments. To make things worse, the latter should also increase in order to better cope with an ever growing level of international competition.

On the other hand, households are expressing a strong preference for liquidity and are increasingly short-termist in their approach to investments: according to the euro area financial accounts flow data, during the last year households directed the bulk of their (shrinking) savings towards currency and deposits while disposing of more than 100 €bn of long-dated bonds (Figure 2).

Figure 2: Euro area aggregated household financial accounts. Flow data. Source: Eurostat.



All the above is progressively leading to a situation where a large timing mismatch will emerge between savings – that more and more investors want liquid – and long-term investments – that by their very nature are not suitable to meet this requirement.

Question #2: *Do you have a view on the most appropriate definition of long-term financing?*

According to the Green Paper 'long-term financing' is required in order to support investments in long-lived productive, *as opposed to financial*, capital goods given that the return from them can be harvested but only after a considerable period of time.

With this definition the Commission seems to play down the role of long-term *financial* investment by mixing the point of view of the economy with that of the end investors. Indeed it is well-known that *from the point of view of the latter*, a long-term commitment to remain invested in a given *financial* portfolio is by far the most common way through which long-lived productive capital goods are indeed financed.

In order to avoid a possible misunderstanding on this relatively simple point, we believe that the emphasis the Green Paper puts on the definition of long-term financing should be changed accordingly. For instance a clear distinction could be made between the economy, which is in strong need of long-lived *productive* capital, and investors, who need the best *financial* instruments and incentives to channel their savings towards this end.

3] Enhancing the long-term financing of the European economy

3.1] The capacity of financial institutions to channel long-term finance

Question #3: *Given the evolving nature of the* ***banking sector****, going forward, what role do you see for banks in the channelling of financing to long-term investments?*

In the aftermath of the financial crisis, banks have been rationalizing their business models by tightening credit standards and adjusting to market and regulator demands for more and higher quality capital. As a consequence there is a large consensus on the view that the future involvement of the banking sector in long-term financing will not resume to the relatively high pre-crisis level.

However we believe that the future role of banks in the European economy will still be prominent for a long time and for at least three reasons.

First, bank loans currently account for the bulk of outstanding non-financial corporate debt: according to the same Commission Staff Working Document for a figure close to 85%. While it is set to decline, it will likely do so at a slow pace, at least in the foreseeable future.

Second, in many European countries the banking sector plays a central role in the financial product distribution system: any new way of channelling savings from retail investors to long-term projects will probably heavily rely on banks, albeit under a different framework (intermediation rather than own account).

Finally, the expertise banks have acquired in the evaluation of creditworthiness of long-term projects will likely be important even in the development of new *non-bank* financing vehicles for that target.

Questions #6 and #9: *To what extent and how can* ***institutional investors*** *play a greater role in the changing landscape of long-term financing? What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?*

In the context of institutional investors there is a fundamental trade-off between *client liquidity* (i.e. the ability of the end investor to transform investment into currency in a relatively short time) and *portfolio maturity* (in this context to be construed as its exposure to long-term illiquid investments).

This trade-off is reflected into the investment regulation of the different products that are available on the market. In this perspective a general distinction can be made between *insurance companies*, *pension* and *closed-end funds* on one hand and *open-end funds* on the other.

Due to the long duration of their liabilities, the former could build, at least in theory, an investment portfolio with long-dated *illiquid* assets. In contrast, the ability of the latter to invest in the same way should be (and actually is) severely restricted in view of their general obligation to fulfill redemption requests *at any time*.

As a matter of fact both insurance and pension provision regulations are moving towards market-consistent valuations and risk-based solvency standards that could negatively affect their ability to act as long-term investors. That calls for a careful consideration of both the process of calibration of Solvency II capital requirements and the future review of IORP Directive in order to make sure that no *unnecessary* obstacle to long-term financing is being introduced.

As regards investment funds, it is straightforward that closed-end products are the first-best option to provide for long-term financing of the economy. However, taking into account that the bulk of the European fund market is represented by open-end funds, we believe that such products should be specifically considered in this context as well.

In particular today UCITS funds account for more than 70% of the 9,000+ €bn European industry. With reference to their possible contribution to the financing of long-term investments, it has been observed that the more risk-oriented tier of the market (e.g. equity and high yield funds) could play a role by making use of the 10% unlisted (i.e. *illiquid*) securities allowance granted by the Directive.

However the point has also been raised that this limit is too tight to allow the development of a full-scale long-term investment fund market in the context of the *current* UCITS Directive framework.

To address this issue it has been suggested to increase the 10% limit or even to drop it altogether; however we believe that this is neither appropriate, nor necessary.

In fact, this threshold is at the root of UCITS regulation and in particular of its distinctive openness feature. Lifting its value would result in introducing a substantial liquidity risk in the redemption process, which in turn would create confusion among investors and endanger the UCITS brand which is recognized as a quality label worldwide.

Instead, we suggest developing a common EU regulatory framework that moving from the UCITS experience would allow for the creation of funds specifically dedicated to long-term financing. Should this new framework be developed as a new category of product within the existing UCITS Directive or as a separate stand-alone regulation, it shall provide for asset eligibility, redemption and borrowing rules appropriately chosen to best balance the long-term approach of investment policy with the liabilities features of the product.

In particular, the scope of eligible assets shall be broadened beyond the current UCITS rules. For instance, long-term funds (LTFs) should be allowed to invest in infrastructure, urban development projects, renewable energies, small and medium-sized enterprises and bank loans.

Redemption rules shall be strictly calibrated to the structure of the portfolio. As a general rule a rise in the weight of illiquid or long-oriented investments should be appropriately matched with a consistent reduction of liquidity liabilities of the LTF through the provision of (longer) lock-in periods or restriction to access to early redemption provision, if any.

Finally, explicit albeit limited borrowing powers shall be awarded to LTFs in order to gain access to an appropriate level of leverage but also to be in the position to smoothly manage the liquidity provision.

A specific regulatory framework would increase LTFs visibility and attractiveness. In addition we deem crucial for their success that they are also granted valuable tax benefits targeted to raise the interest of short-term oriented retail investors. Should they eventually decide to trade the liquidity of part of their savings with the participation in the long-term investment of the economy, the cost of the tax breaks would be likely fully repaid in the mid term.

Should the Commission decide to work towards the development of the proposed LTF framework, we stand ready to give our full support with a further detailed analysis.

3.2] The efficiency and effectiveness of financial markets to offer long-term financing instruments

Questions #11 and #12: *How could capital market financing of long-term investment be improved in Europe? How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically, socially and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?*

Policy makers intent on unlocking new sources of long-term finance should foster the growth of new markets and instruments that can help fill the gap between the current sources and projected future demand for long-term investment.

While US bond, equity, and securitization markets are mature and liquid, this is not the case in much of the rest of the world. Hence banks are and will remain for the medium term the dominant source of external financing outside the United States. However commercial bank loan maturities average only 2.8 years in emerging economies and 4.2 years in developed economies—far shorter than bond maturities.

Over the medium to long term, there is large scope to increase the size of corporate bond markets in Europe, in several other advanced economies, and in emerging economies so that they could complement the continuing important role that banks must play. For example, according to Group of Thirty estimates, if companies with more than US$500 million in revenue in Canada, France, Germany, Italy, Spain, and the United Kingdom were to obtain 80 percent of their credit from bonds rather than loans—less than what we observe in the United States for companies of this size—the corporate bond market could potentially grow by US$2.7 trillion, or 32 percent, over a long period of time.

Bank lending will remain an important source of financing in Europe. However, with the right standards and regulations in place, more small business loans could be packaged into securities and sold to investors, enabling banks to extend more credit.

Prudent growth of new bond, securitization, and equity markets, adequately overseen and supervised, must be part of the solution to the long-term finance problem.

3.3] Cross-cutting factors enabling long-term saving and financing

Questions #15 and #17: *What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed? What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?*

In our reply to Question #2 above we suggested that from the point of view of the end investor a long-term commitment to keep its savings invested is by far the most common way through which long-lived productive capital goods are and could increasingly be financed.

Taking into account that taxation influences considerably investment decisions, we believe that setting specific cost-efficient tax benefits that favour long-term commitment of savings is an *essential part* of the general plan to foster the long-term financing of the European economy.

Consistently with this view, a few European countries have already granted retail investors tax relief when investing in the long-term: Individual Savings Accounts (ISA) in UK and Plan d'Epargne en Actions (PEA) in France are two major examples.

Since 2011 the Italian law generically provides with a long-term investment related tax break. However the implementing and detailed regulation is still lacking and as a consequence it has not been applied yet.

In this context Assogestioni has published a proposal on how the Italian saving plans could work in practice. The 'PIR' (Piani Individuali di Risparmio) solution combines elements of the French

solution and the UK ISA and could be the basis for building a European standard. It could also be assumed by those Member States that still do not have such a regulation in their tax code.

In particular, in order to be eligible for the tax reduction a PIR account must be opened by a retail investor with an intermediary (e.g. a bank, an investment company or an asset management company) for such specific purpose.

Income and capital gains from investments made through a PIR shall be taxed at a rate lower than the ordinary one provided savings are held in the plan for at least five years. Higher tax discounts shall apply to longest holding periods (as in the case of French PEA) and the highest benefits shall be granted after a holding period of ten years or more.

Once in the PIR, savings can be invested in a full range of financial instruments: equities, bonds, investment funds, insurance products and even cash. Should diversification or liquidity features be desirable, a set of investment compliance rules could be introduced accordingly.

It is important to note that PIRs are long-term *savings* plans but not necessarily long-term *investment* plans. Indeed the portfolio composition can be changed at any time and provided savings are kept into the account, they will retain the tax privileged treatment. However there should be no restriction on when or how much money can be withdrawn from the plan.

Finally, in line with the French and UK plans, each fiscal year PIRs may receive only a limited amount of money; should this limit be passed the surplus will not be granted any particular tax benefit.

3.4] The ease of SMEs to access bank and non-bank financing

Questions #26 and #29: *What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance? Would an EU regulatory framework help or hinder the development of this alternative non-bank sources of finance for SMEs? What reforms could help support their continued growth?*

The declining availability of bank finance calls for a prompt policy action to promote the development of alternative, non-bank channels for SME financing. To this end, both debt and equity capital markets should play a key role. In this perspective a couple of interesting initiatives have been recently launched in the Italian market.

In 2012 Consob, the market watchdog, together with the most prominent finance and industry associations, launched an action plan named "PiùBorsa" consisting of a number of commitments and activities aimed at improving SMEs access to the equity market. In fact, these companies, which represent the bulk and, in many cases, the most innovative tier of the Italian production

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In 2012 a legislative initiative has introduced a new sound and tax efficient framework for developing alternative financing instruments for Italian *non-listed* companies. The new legislation aims at facilitating the issue of short-term debt (commercial paper) and mid to long-term debt (notes named 'mini bond' for the occasion) by these entities for which the previous regime was considered too penalizing.

In particular, the strict quantitative limit to the amount of notes a non-listed company could issue under article 2412 of the Italian Civil Code has been removed, provided the notes are (or are expected to be) listed on a regulated market or a multilateral trading facility (MTF).

In addition, the taxation regime for notes issued by unlisted companies has been aligned with the more favourable regime for listed companies. In fact, to make notes a real alternative to loan

financing the new law has introduced provisions that, on one hand, make the issue more tax-efficient for the issuer and, on the other, should increase the interest in those financial instruments for potential investors.

In particular, regarding the *issuer* the law aligns the rules relating to the tax deductibility of interest expense on notes issued by unlisted companies with the regime that applies to listed companies, provided that the subscribers of the notes are qualified investors who are not the direct or indirect shareholders of the issuer. In relation to the tax regime that applies to the *investors* the same law extends the exemption from the 20% withholding tax on interest and other proceeds to notes issued by unlisted companies, provided that the notes are traded on a regulated market or on an MTF.

Italian Banking Association (ABI)

General comments

ABI appreciates the opportunity it has been given through the publication of the Green Paper on long-term financing of the European economy to provide its own contribution to the discussion on long-term investments and the ways to finance them. ABI shares the emphasis on the urgent need for policy measures capable of stimulating the flow of savings over to investments aimed at relaunching competitiveness and productivity and, therefore, capable of encouraging the recovery of the European economy.

To achieve this objective, it is absolutely fundamental that there is total convergence at an EU level and within the individual Member States about what policies to adopt. ABI, therefore, would like to stress that the recipients of the answers provided by the financial industry to the various questions raised by the Green Paper ought to be the relevant EU and national institutions.

Long term finance is vital for sustainable growth and for the durable recovery of the European economy. The growth must involve the entire Europe and particularly contribute to untie the tangles of the imperfect monetary Union represented by the Eurozone. Companies and markets are mostly compelled to achieve this convergence, but adequate support policies are needed.

For this purpose ABI illustrates its position related to the questions raised by the Green Paper, underlying:

- on the one hand, that the banking sector plays a central role in long-term financing not only by the traditional activity of raising funds through savings and the provision of loans, but also through the commitment undertaken in private equity funds and in projects aimed at facilitating SMEs' direct access to the equity and debt securities market;

- on the other hand, the need for measures able to better coordinate the prudential and fiscal rules with the aim of relaunching investments and stimulating the flow of savings.

Answers to questions

Question 1: Do you agree with the analysis outlined above regarding the supply and characteristics of long-term financing?

Answer - On reading the document, the analysis seemed a little incomplete in parts and not totally convincing; therefore, we believe it would be useful to redraft it starting from the trend in savings and capital accumulation in the Eurozone by using Eurostat data.

If one compares the five-year averages from before and after the financial crisis with the forecast data for the 2013-2014 two-year period, one can note that the problem today is more on the demand side for funds than the supply side. In particular:

- if in the 2003-2007 five-year period investment represented 21.2% of GDP and savings were 21.7%,
- during the five-year period of the crisis both aggregates reduced their incidence on GDP by 1.6-1.8 percentage points, leaving the gap substantially in favour of savings;
- the forecasts for the next two-year period estimate that there will be a recovery in the incidence of savings (20.4%), while the flow in investments should continue to fall (18%), thereby creating an ample savings glut, a faithful mirror image of the current policy structure totally bent on re-balancing deficits in the weakest countries.

With regard to this picture, foreign direct investment (FDI) flows merely continue to exacerbate the savings glut. In particular, bearing in mind that the net flow of FDI (as opposed to what is suggested in the text) is structurally negative for the Eurozone (down 1.3% of GDP in the pre-crisis five-year period), the latest figures lead us to believe that during the next two-year period this negative balance will be quite modest (-0.5% of GDP according to our forecasts). Consequently the savings total and FDI should reach 20% over the next two years - a figure substantially in line with the pre-crisis figures (20.3%) and 2 percentage points higher than the flow of investments.

Therefore, as a first conclusion, the fundamental policy point is how to allocate investments in the knowledge that at least over the medium period there are important savings reserves in Europe.

With regard to this aggregate picture, however, the real weakness in the EU is the extreme diversity of situations and dynamics among the various member states. In 2007 the substantial balance between savings and investments within the Eurozone consisted of a savings glut of 7.5 percentage points of GDP in Germany, that contrasted with the deficits, excesses in investment, of 18 p.p. in Greece, 10 in Spain and Portugal, 5 in Ireland and 1.3-1.4 in Italy and France. In the following 5 years, the deficit adjustments in weak countries was not accompanied by a similar surplus adjustment in strong countries and this explains why in 2012 the area as a whole displayed a savings glut of 1.6 points of GDP: in detail in 2012, Greece showed a deficit of 5 p.p. of GDP (an improvement of 13 p.p.!), Portugal reduced its deficit to 2 p.p., Spain to 1 p.p., Italy to 0.5 p.p. and Ireland had significantly reversed the trend with a savings glut of 6 p.p.; throughout this, Germany continued to show a surplus of 6.4 p.p. of GDP. According to projections, in 2014 only France will show an excess in

investments of 1.8 p.p. of GDP, whereas all the other countries will display ample savings gluts.

Obviously, the improvements over the last 5 years in poor countries are to be ascribed solely to a sharp fall in investment activities, since the capacity for savings has been reduced considerably in all the countries taken into consideration, except for Germany where it remained stable.

But let us come to the second point and that is the division between short-term and long-term savings. If we analyse the ECB figures for net flows of financial asset purchases by families, we can confirm that the long-term asset share has fallen significantly: in the five-year period before the crisis, long-term assets represented 55% of purchases by European families, whereas in the 2008-2012 five-year period this share fell by 15 percentage points. This reduction, however, is mainly due to the fall in purchases in investment funds (which in the five-year period of the crisis has seen disinvestments of an average of over 70 billion Euros per year) and in long-term securities (probably state bonds), whereas share purchases have reacted positively: in the pre-crisis five-year period, these amounted to 3.4% of total purchases and in the post-crisis five-year period this quota rose to 16%, probably feeling the effect of the issue programmes by the major European bank groups while waiting to adjust to the dictates of Basel 3.

The extreme volatility in the financial markets, which obviously increased the risk aversion of families, as well as the demand for liquidity were highly significant factors in causing this reduction: it was no coincidence that in the five-year period of the crisis, the flow of liquid assets and deposits stood at 55% of total financial asset purchases, as compared to a figure of 42% in the previous five-year period.

But what also really explains this preference for liquidity is a particularly difficult situation for family budgets which means that the larger quota of liquid instruments is more a need rather than an investment choice. In fact, if we consider trends over the last three years (the period of the Euro crisis), one can see that where the aggregate savings rate improved by 1 percentage point, this was due mainly to an important programme in re-balancing public accounts: the savings rate of the General government has in fact improved over the three-year period by 1.6 p.p.. On the contrary, the incidence of savings in families over GDP worsened by 1.7 p.p., whereas the figure for enterprises improved by 0.8 p.p.. Obviously in a situation where there is a generalised reduction in consumption, this fall can be explained by a reduction in available income resources - a fact that in itself determines an increase in the proportion of liquid assets held for precautionary and settlement purposes.

On the basis of the above and with the current, substantially recessionary structure of European policy, it is quite likely that the quota of long-term assets will still remain below the pre-crisis averages for a long time.

Consequently, if there is a desire to revitalise the demand for long-term assets from families, some action will firstly need to be taken with regard to family income conditions with improvements that will allow them to plan their financial choices on a longer-term investment front. Although this might not be definite, it could lead to a revision of the policy choices followed until now. Obviously a thrust in family incomes would also have positive effects on the demand for investments, which, as we mentioned above, is clearly depressed.

Secondly, due to the increased risk aversion of savers, which we believe is an inheritance from the crisis likely to last for some time, an assessment will have to be made about offering long-term financial instruments of a certain liquidity, i.e. less subject to losses/gains in capital account, such as for example fixed-term deposits.

Obviously in Europe, the necessary solutions are not the same everywhere, so the topic of recovery in family income conditions is a priority in peripheral countries (but also in France), whereas probably the subject of savings instruments is more important for Germany even though it may not be imperative, given the inclination of German savers for long-term products.

Question 2: Do you have a view on the most appropriate definition of long-term financing?

Answer – In general, we share the approach followed in the document aimed at identifying the characteristics of long-term financing based on certain production investments (as opposed to financial ones), given that such investments have specific characteristics (reduced liquidity, generation of deferred cash flows, complexity of risk assessments).

Nevertheless, we believe that the association between medium to long-term financing and productive investment as proposed in the document may be excessively binding when talking about raising resources on the financial markets, where such relationships are not also so pressing. For example, if we accepted the proposed indication, we would have to state that an IPO may be considered as a long-term financing operation only if the raised financial resources were intended for specific productive investments aimed at the construction of long-term capital goods, and not also for an acquisition operation, or to improve the company's system of internal reporting.

Question 3: Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

Answer - We feel that we can agree with the conclusions of the proposed analysis, but only tendentially, in the sense that we believe it is probable and also desirable that a part of the financing of long-term business projects may also find solutions that are different from seeking bank credit. In this sense, it is necessary to look at the comments made regarding "to facilitate SME access to alternative sources of finance" - see Q26.

Conversely, we do not agree with the intensity of the phenomenon, as described in the text, or with other related assertions. To debate this point, we shall use the ECB's financial accounts according to institutional sectors and we will analyse the trends over the last five years of the crisis period which lies at the centre of the proposed analysis.

Firstly it should be clarified that long-term financing to European businesses has grown: if we consider the ratio between long-term financial debt of businesses (loans, bonds and other financing methods) and GDP, this increased by 6.1 p.p. between the end of 2007 and the end of 2012 (from 52.1% to 58.1%).

Bank loans contributed towards this increase with 1.6 p.p., loans from other investors with 0.5 p.p., whereas the dominant role was played by the 4 p.p. increase in the issue of bonds by businesses: in this way, the quota of bank lending over the total long-term debt financing of businesses fell from 66.2% at the end of 2007 to 61.9% in 2012. On the basis of these figures, it is possible but not essential to imagine a scenario, as the proposed analysis does, that the role of banks in long-term financing may fall significantly over the coming years, both in terms of quality and quantity, thereby substantially changing its way of relating to enterprises and also the composition of its earnings.

But the average figure in the Eurozone is feeling the considerable effects of certain national "critical aspects" which have led to programmes supporting the related bank sectors with a consequent reduction in the weight of credit intermediation in those countries: in particular, it emerges from the analysis of the figures that there was considerable deviant behaviour on the part of Spanish and Irish banks. In order to assess to what extent these critical aspects have affected the overall figure, we calculated a new aggregate figure which subtracts from the Eurozone average the dynamics of the two mentioned countries (which, for the sake of information, represent 18% of total bank loans to businesses in the Eurozone).

Now if we recalculate the former indicators, we can see that in the face of an increase in long-term debt financing of businesses of 6.6 p.p. (6.1 previously), the contribution made by bank loans now increases to 3.8 p.p.

(vs 1.6 previously) and other financing methods reduce their incidence on GDP by 1.6 p.p., whereas bonds maintain their primacy with an increase of 4.4 p.p. of incidence on GDP. In this case the incidence of bank financing over the total of long-term debt financing continues to fall, but only marginally: from 62.7% in 2007 to 62% in 2012.

Furthermore, such a limited reduction in the bank lending quota and increase in corporate bonds does not seem to be a widespread phenomenon in all Eurozone countries but reaches a significant peak in France, where the weight of corporate bonds over GDP increased by 10.1 p.p. over the five-year period (with, nevertheless, an increase of 4.6 p.p. in bank loans), reaching a total of 38% of long-tern debt financing of French companies (compared to the European average of 21% net of Spain and Ireland). The German situation dampens this performance, where the weight of bonds over the total of long-term debt-financing to businesses stood at 9.7% in 2012 - up by 2.1 p.p. over 2007, but nevertheless not significantly higher than the growth in bank lending (up 1.8% to 63.8%); the Italian experience, despite the difficulties in Italy, highlights dynamics that are substantially in line with what occurred in Germany, even though there was greater dynamics in corporate bonds (up 3.9% to 11.2% in 2012).

Therefore, one can state that over the last five years, regulatory reform and the banks' own needs have encouraged a more significant role in direct financing by enterprises, in particular in the form of borrowing through bonds. Nevertheless, net of the crisis situations in some national banking systems (particularly Spain and Ireland) and of a national path taken by France, this re-composition seems more to make way for a re-balancing of the weight of bank credit which also meets the requirement for improved distribution of credit risk which up to now has mainly been borne by banks. This re-balancing could come to a close once a new level of equilibrium has been achieved in bank involvement in the long-term financing of businesses. We also have a different opinion compared to the one expressed in the text, as regards the dimension of the distance between the current balance level and the final balance level: we feel that, at the moment, there is no clear, uniform evidence for the different EU countries and so we believe at the moment that this distance will not be particularly great.

Question 4: How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?

Answer - Multilateral development banks could, in a coordinated fashion, raise the ceilings of funds made available by national banks for the purposes of financing businesses following the model of the EIB global

loans. It would, however, be appropriate for such funding to have particularly long maturities, that are not usually available for financial intermediaries in the market. The access procedures should be simplified and should not necessarily require the assignment of the bank loan underlying the financing transaction, so as to encourage the channelling of resources to the business system, with advantageous economic conditions.

It would also be necessary for the loans under examination to have the possibility of using guarantees from multilateral banks following the EIF model of risk sharing, at least as regards the risk of default relating to the later amortization instalments.

Question 5: Are there other public policy tools and frameworks that can support the financing of long-term investment?

Answer - With the worsening of the economic and financial crisis and the consequent difficulties for Italian banks to have access to traditional long-term funding channels in the international markets, the Italian Government has issued over recent years a series of regulatory provisions that have extended the mission and activities performed by the *Cassa Depositi e Prestiti S.p.A.* (CDP) in support of the economy, also through raising State-guaranteed postal funds.

On this point, from its traditional role as long-term financing body for Public Administration investments, the activities of the CDP now also include the financing of SMEs, of enterprise internationalisation, of infrastructures in project financing and social housing, also in a way that is coordinated with the banking system. In addition to loans, it now offers equity investments through Italian and European funds.

In particular, the collaboration between the *Cassa Depositi e Prestiti* and banks in identifying the measures to support enterprises in this difficult economic situation has produced, over recent years, a series of instruments, whose rules of use have been governed by specific agreements between the CDP and ABI.

Four different agreements have been signed by ABI and CDP since 2009, which have enabled CDP to provide the banks with an overall financial plafond of 18 billion euro, divided into two tranches - one of 8 billion and the other of 10 billion - with the aim of encouraging a greater flow of medium and long-term resources for small and medium-size enterprises.

The overall allocation of the first tranche of 8 billion euro was used to the full, facilitating the financing of over 53 thousand enterprises with advantageous conditions.

The second tranche of 10 billion euro (the so-called “New SME Palfond”) became operational on 1 March 2012, with the signing of the fourth ABI - CDP Agreement, and is divided into the following two sub-tranches:

- the “Investment” Plafond with a value of 8 billion euro for financing initiatives relating to SME investments that are under construction or for future construction and for SME working capital needs;
- the “PA debts” Plafond which has a total of 2 billion euro which may be used by banks to finance all permissible kinds of transactions on credit claims that SMEs are owed by the Public Administration and certified under Italian Decree Law No. 185/2008 (assignment without recourse, assignment with recourse, banker's advance with or without credit assignment).

The economic and financial crisis has had a significant effect above all on infrastructure financing operations according to project financing schemes, since banks have become more selective in their screening of projects to be financed, also because of the restrictions imposed by the Basel 3 regulations.

The Government has issued new measures in recent years that may further and more effectively encourage the use of private capital in the construction of public works.

One of these measures that is particularly worth mentioning is the project bond, introduced into the Italian legal framework by Italian Decree Law No. 1 dated 24 January 2012, which in particular allows project bonds to be guaranteed during the construction phase of the building project. It will therefore be possible to issue project bonds, using investors' loans to contribute towards financing the more risky construction phase. With project bonds, therefore, one could facilitate the involvement of new entities in financing infrastructural projects, such as pension funds, investment funds, insurance companies and sovereign funds.

For financing infrastructural projects within the Italian market, banks also offer mixed operations known as “Mini-Perm”, which finance the construction phase (with operations over 5-6 years) with options to refinance the debt at the end of the construction phase or within a few years.

One could also imagine the use of tax relief mechanisms on loan interest for businesses that make medium to long-term investments that have social value, for example, in terms of employment or environmental policy.

However, there is a need for actions aimed at establishing a clear regulatory framework which offers guarantees of stability and continuity in the rules, particularly with reference to incentives and (direct and indirect) investment support. It often happens, particularly in Italy, that when rules are

introduced they are subsequently amended during the project construction phase, leading to conditions of uncertainty among investors and their operators, firing litigation and increasing the time required for the construction work and actually producing an investment disincentive. Regulations need to streamlined, coherent and harmonised among the various sectors (which are, in fact, in competition with each other for attracting private capital) and the procedures need to be transparent so as to encourage effective decision-making processes within appropriate time-scales.

Question 6: To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

Answer – In a market phase where the applications for loans from SMEs cannot be fully satisfied within the banking system, the savings management industry can play an important role by putting businesses into contact with investors through investment solutions which allow access to the SME bond market, an asset class where individual investors are unlikely to be able to invest directly with adequate diversification. It is really a matter, on the basis of the experience gained in certain European countries (e.g. France), of encouraging the development of investment funds, mainly of the closed type, specialised in investing in debt instruments of medium-size enterprises, capable of correctly selecting the businesses to be financed, of adopting policies for diversifying the portfolio and managing risk and the limited liquidity in the underlying loans. For this purpose, a simplified authorisation procedure with the competent Authorities could be established to allow more rapid growth and marketing of such entities, as well as the possibility for financial institutions, also from the public sector, to subscribe minority holdings in such investment entities.

In the short term, due to the lack of specialised investors, it may be possible to propose that a considerable contribution in support of medium-term financing could also come from open investment funds that invest in non-liquid financial instruments issued by SMEs (in line with the limitations imposed on them by UCITS regulations) as well as by pensions funds.

Question 7: How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, re-insurers and pension funds, such as IORPs?

Answer – In compliance with the provisions of the IORP Directive[1], we believe that the regulation of investments in the supplementary pension sector should draw inspiration from the "prudential person" principle based on careful definition of the decision-making processes adopted for selecting

[1] See Directive 2003/41/EC relating to the activities and supervision of collective or professional pension schemes.

investments, on the knowledge and management of risks associated with investments rather than on the mere imposition of quantitative limits.

The “prudential person” regulations, in fact, pursue the optimisation of the ratio between profitability and risk through recourse to organisational and professional facilities within the funds, to decision-making processes that are adequate and proportionate to the assets they manage and the occupational retirement provisions.

This approach to investments allows efficient risk-yield combinations to be sought over a period of time that are consistent with the time that pension payments are provided (typically over the medium to long-term) and, therefore, allows resources intended for retirement benefits to be maximised thereby exposing adherents to a level of risk deemed acceptable.

Within this context, pension funds can certainly play a positive role in supporting medium to long-term investments capable of guaranteeing adequate profitability and exposure to risks that are compatible with the adopted investment policy.

In Italy, we are still waiting for the new ministerial decree to be issued which absorbs the IORP Directive and revises the current approach to regulating pension funds which unduly limits the possibility of pension funds to make investments.

Question 9: What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?

Answer – In addition to facilitating the direct access of businesses to the capital markets (as debt and equity), it would also be appropriate to facilitate the development of investments in risk capital in unlisted enterprises made by private equity funds, through initiatives aimed at increasing the number of investors and investment opportunities, thereby creating the conditions for a wider private equity market.

In this perspective within the Italian experience, an important contribution has come from the Italian Investment Fund, whose capital was subscribed by important Italian banks and other financial institutions (including public ones) and which performs activities as the Fund for private equity Funds - by investing in the capital of entities which make private equity investments consistent with the investment strategy of the Fund itself - and also in medium-size enterprises with the aim of helping enterprises to develop.

In this context, it is worth considering that long-term financing by institutional investors could act as a springboard for the development of other means for raising funds by less expert investors, through the

assurance function of due diligence performed by them in assessing the appropriateness of the investment. For example, one should consider the financing segment in innovative start-ups through on-line portals, whose system of regulation has been developing over recent months in Italy, presumably with the provision of a specified threshold for institutional investments as a minimum condition for accessing non-institutional investors' capital through on-line portals.

Question 10: Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?

Answer – In the CRR/CRD 4, the Regulators are aware of the subject of "long-term investment" but are deferring the examination of the subject to the end of 2014 as can be seen in articles 478b and 485a of the CRR[2].

In the future it may be possible to address the issue by proposing a downward revision of requirements:

- at least up to a maximum overall agreed amount, established on a percentage basis of each bank's portfolio;
- even if the operations were in the name of small or medium-size and/or externally non rated entities;
- even if they were singularly of an insignificant amount (consider, for example, green energies).

Having said this, there are other reforms in the process of definition which might have some counter-productive effects for the banking sector in relation to long-term financing.

The most significant of these is contained in the European Parliament and Council proposal for a Directive which would institute a framework for recovery and resolution of the crises in credit entities and investment enterprises. In particular, the proposal to exclude short term liabilities from the bail-in field of application produces a perverse incentive for banks to invest in the short term, because it makes them less risky and therefore less costly in terms of funding. In parallel fashion, long-term assets become

2 Article 478b Review of long term financing
By 31st December 2014, the Commission shall report to Parliament and Council, together with any appropriate proposals, about the appropriateness of the requirements of this regulation in light of the need to ensure adequate levels of funding for all forms of long term financing for the economy, including critical infrastructure projects in the European Union in the field of transport, energy and communications.
Article 485a Long term financing
The Commission shall report on the impact of this regulation on encouraging long-term investments in growth promoting infrastructure by 31st December 2015 and we find the following wording in the report. Therefore the CRR side regulator is considering the subject of long-term financing but is deferring the problem into the future.

riskier and therefore more expensive in terms of requested remuneration (see also the answer to question 20).

Question 12: How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?

Answer – For some years now, the main market management companies, also driven by the changes introduced by new regulations, have been promoting “trading venues” (Multilateral Trading Facility) for trading in SME shares intended for professional investors and characterised in general by procedures and admission and permanence expenses for issuers that are less onerous than those on the regulated markets. Some markets for SMEs (e.g. AIM UK, Euronext) already possess the requirements to attract enterprises that also come from other countries. In other markets that are more nationally-based, there is a need to increase the number of specialised investors in that asset class by also involving financial institutions from the public sector in different ways, as already stated for private equity investments.

More recently the financial crisis highlighted the need, above all for SMEs, to diversify their financing sources when raising the necessary financial resources by way of debt directly in the market. In addition to the EMTN market, therefore, a number of nationally-based platforms have been developed to encourage the trading in securities issued by enterprises and also a number of markets intended for unlisted private placement issues (e.g. the German Schuldschein market).
The fragmentation on a national level of markets for SME debt securities does not favour the raising of financial resources by SMEs. It would, on the other hand, be useful to promote a single unregulated European market for bonds issued by SMEs, which have standardised access and permanence procedures and documentation and also modest costs for placing instruments.

Question 13: What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?

Answer - The diversity in regulation regarding covered bonds is a result of the different regulatory frameworks in the Member States, in particular with regard to bankruptcy laws and the different supervisory provisions which issuing banks must be subject to. Harmonisation of the various series of regulations governing covered bonds must, therefore, be accompanied by a wider harmonisation of regulations in general. In effect, the current

situation has led to worthwhile competition between the various national regulations so as to be more attractive to investors, encouraging a process of financial innovation. On the other hand, it is clear that a greater harmonisation in the field of covered bonds would encourage the penetration of these instruments on the international market, thereby reducing the costs of analysing the transactions and encouraging the liquidity of this asset class.

Question 14: How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?

Answer - The fundamental point, which is however the subject of highly advanced initiatives, is to improve the transparency of the securitisation market. It could also be appropriate, however, in this delicate phase of relaunching the market, to provide for appropriate public guarantee instruments in relation to equity tranches of ABS issues.

Question 15: What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?

Answer – In Italy there is a lack of an organised system of regulations for long-term saving solutions, even if there are some specific models for sectorial regulation, such as postal savings books which are referred to in Note 28 of the consultation document. In particular, the provision contained in Art. 2 (7) (d) of Italian Law Decree No. 138 dated 13 August 2011 (converted into It. Law No. 148 dated 14 October 2011), according to which for the yields of "appropriately-constituted long-term savings plans", there should be a reduced rate of 12.5% (compared to the ordinary rate of 20%) that has remained unimplemented. At the moment, this reduced rate, however, only remains applicable to State Bonds (or State equivalent bonds) and to Post Office savings certificates, which however enjoy a competitive advantage compared to similar products of private issuers.

Please also refer to the comments made in answer to Q17. It is worth underlining, however, that indirect taxation can also have a significant effect on savers' choices: in 2012 Italian legislation on stamp duty introduced some differences in treatment between (post office and bank) current accounts and savings accounts, on the one hand, and other forms of investment in financial products, including deposits. This situation drew the attention of the Competition Ombudsman (*Autorità Nazionale Garante della Concorrenza*), who was of the opinion that this approach led to certain discriminatory effects to the detriment of deposit accounts, which the Garante himself recognised as having a role as "an extremely competitive method of savings also addressed to small savers".

On the basis of this example, it would appear right to highlight the fact that if discussions were held at an EU level on a possible EU model for "savings accounts",it would be appropriate to direct attention towards any possible discrimination between products.

Without wanting to make conjectures here about solutions based on forms of tax harmonisation in the relevant national legislation - which we know is difficult to achieve - an intermediate objective might be to seek confirmation from EU Authorities in the form of a soft law, regarding the principle of equality in tax treatment, at a national level, for all those financial products that EU legislators intend to promote and those products which substantially perform a similar function. This principle should be upheld with regard to direct and also indirect taxation.

Question 16: What type of CIT reforms could improve investment conditions by removing distortions between debt and equity? Question 18: Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities? Question 19: Would deeper tax coordination in the EU support the financing of long-term investment?

Answer – The issues associated with the distortions between debt and equity have been addressed in a positive manner by Italian legislators in the recent introduction of the so-called ACE – "Aiuto alla crescita economica" (Help with economic growth) - which has been operational since the 2011 tax year.

This mechanism aims to encourage the strengthening of the equity structure of enterprises and the Italian production system, through a tax incentive which intends to restore a balance in treatment between businesses that finance themselves through borrowing and those that finance themselves using their own equity. In particular, a reduction in corporate tax was introduced calculated in line with the new capital invested in the business in the form of cash contributions from shareholders or the allocation of profits to reserves.

The positive nature of this choice made by Italian legislators to reward more virtuous businesses that reinforce their own equity structure, by reducing taxation on income assignable to risk capital, was also openly acknowledged by the International Monetary Fund[3] : "The recent introduction of an Allowance for Corporate Equity (Aiuto alla Crescita Economica; ACE) has eased the tax bias toward debt finance and made equity injections more attractive. By providing a tax deduction for a notional return on additional equity injected into companies, this system reduces the cost of such finance

[3] October 2012 - IMF Country Report No. 12/280 - Italy: Technical Assistance Report—The Delega Fiscale and the Strategic Orientation of Tax Reform.

and eases the tax incentive to use debt rather than equity finance. These are very attractive properties—the importance of avoiding tax incentives to artificially high leverage, especially but not only for financial institutions, has emerged only too clearly since 2008. Given too the positive experience of several countries with ACE or similar systems,14 many now advocate widespread adoption of the ACE.15 With its own past experience of forms of business taxation with ACE-type features, this is an area in which Italy has been a leader—and is now once again".

It is clear that the adoption of isolated initiatives by individual countries, even if they are positive, can lead to disalignments among the tax laws within the EU which could conversely lead to undesired effects: the Italian banking system has on several occasions expressed its approval for greater tax coordination within the European Union, supporting the project to create a harmonised tax base for corporate taxation in Europe (CCCTB). The difficulties encountered in trying to achieve this project, which has not registered any significant development since the presentation of the proposal for such a directive, should therefore be addressed also in the light of the comments made so far.

Question 17: What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?

Answer – Returning to certain concepts already introduced in answer to Q15, it is worth underlining the extremely delicate nature of any decision made in favour of one form or another of savings.
These are actions that need to be meditated very carefully so as to avoid any possible distorting effects made by such advantages, which could easily lead to alterations in the level of competition between products and between intermediaries.

With this in mind, any wordings that are too generic need to be avoided - such as for example the wording of the afore-mentioned Italian law from 2011, which remain unimplemented due to its excessive vagueness. Similarly, it is important to avoid the tendency of introducing an *ad hoc* regime for long-term investment options characterised by their compliance with a determined structure, given that these options risk providing advantages for just a few specific products (or specific issuers/intermediaries) and not others.

In particular, regulations that are favourable for long-term saving should:

- encourage savers to hold investments over a long period, without paying attention to the expiry date of the issue (thereby avoiding making distinctions similar to those previously used in Italy that

penalised issues of short-term bonds compared to medium to long-term bonds).
- make sure that the incentives are provided regardless of the kind of instrument, i.e. regardless of whether they are shares or bonds or investment funds or insurance policies of a financial nature or other forms.

In addition, correlation with the other existing regulations should not be neglected, in particular Basel 3, so as to avoid any undesirable effects on tax regulations. The provision of forms of tax advantages for long-term savings may also have effects on the LCR (Liquidity Coverage Ratios) of banks, since customers could be induced to move their investments to assets with tax advantages. With this in mind, the introduction of solutions that discourage the early exit from "plans" prior to the conclusion of the established investment period could also be seen as a reasonable idea.

Having said that, it is absolutely essential to make a critically important comment: before making conjectures about incentives for savings, the EU legislators should make sure that an optimum reference framework for the formation and use of such savings is in place, thereby avoiding the introduction of contrasting and, therefore, distorting elements. In this perspective, the concern with ensuring the creation of incentives for long-term investments appears in contradiction with the proposal to introduce a financial transaction tax which, according to the Commission's proposal, should also affect transactions of both public and private debt securities.

Therefore, we would take the opportunity of this consultation to confirm our opposition to the idea of a direct tax on financial transactions in the secondary market for bonds, since this would have a negative impact on the financing capacity of enterprises, that this Green Paper would now like to safeguard.

Question 20: To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

Answer – Financial reporting should provide information to investors that are useful to their economic decisions. To assist investors, financial reporting should be transparent, should reflects the effects of economic risks while avoiding introducing artificial volatility as a result of accounting requirements.

Fair value accounting provides an appropriate accounting base for financial instrument held for trading purposes or otherwise managed on a fair value basis within the business. When the underlying strategy is to draw a benefit from short term variations in the value of the instruments and where the entity is actively engaging in opening and closing market risk positions, fair

value is appropriate as cash flows that can be generated are mainly determined by the prevailing terms and rates on the financial markets. It also predicts the ability of the entity to take advantage of opportunities or to react to adverse situations.

In other situations, for example, banks' loan books, fair value information can be usefully disclosed but recognising fair values in the financial statements makes it more difficult for users to understand net margin and loan losses, which are widely used measures of financial performance. The change in the value of net assets that would reflect market's perception for portfolios that are not traded would not reflect the cash flow income that will be achieved in practice. If the instrument is held for use in the business to generate cash flows earned on an ongoing basis over a certain period and where is no intention to profit from the short term market movements, amortized cost provides more appropriate measurement basis. Only information that will assist in understanding the timing of the potential cash flows, credit risk and probability of default will be relevant and useful for the users.

Financial reporting must reflect the business model and avoid introducing artificial volatility. There are increasing calls for disclosure to better explain entity's business model in terms of how the entity creates, delivers and captures value and the link between the business model, its risks and how they are managed and the results as reflected in the financial reporting.

Where fair value introduces volatility that does not reflect the economic risks or is not considered to provide useful information the confidence in the reporting is reduced. Disconnect between the actual business model and the accounting could undermine the quality of financial statements and the ability of financial reporting to explain the results, as is increasingly being demanded by users. The financial statements become harder to interpret, increasing the costs of analyzing the financial information and decreasing the company's attractiveness to investors.

While IFRS 9 refers to the entity's business model as part of the criteria for classifying financial instruments, its impact will need to be considered carefully. It may, inadvertently introduce more fair value accounting that does not in fact reflect the business model. For example, it would require that most equities and certain debt securities (those which do not meet the "solely payment of principal and interest" test) be measured at fair value through profit or loss, in contrast to IAS 39. While it would also take fair value movements related to own credit out of profit or loss, overall the transition to IFRS 9 could make financial reporting more difficult to interpret if the business model in terms of IFRS 9 does not reflect how the entity operates in practice.

If designed in a way that is not reflective of the economic substance of financial transactions, changes to accounting framework may also result in

structural changes to the business or investor behaviors. The ABI is indeed concerned about the wider economic impact of the accounting requirements. For example many debt securities issued by banks have features which require interest to be suspended if, for example, the bank is unable to remain solvent immediately after the payment. If additional interest does not accrue on the deferred interest, the instrument will have to be fair valued through profit and loss that may negatively impact the attractiveness of investments in bank's bonds.

There are similar concerns with contingent convertibles and bail in bonds, which are an increasing feature of the regulatory environment for banks. The ABI is concerned that the accounting requirements could have implications for the market for such instruments, and changing the instruments to meet amortised cost requirements would defeat the regulatory objectives.

Not only the use of fair value, but the economic impact of the accounting rules in broader terms should be examined such as for example the new provisioning model that is currently being discussed by the accounting standard setters. The ABI is supportive of the objective to achieve a sound expected loss provisioning approach promoting more forward looking provisioning through timely identification and recognition of credit losses. It must be however ensured that any new expected credit loss model does not disadvantage loan portfolios with longer maturities and does not discourage long term lending, particularly at the bottom of economic cycles and in emerging economies. As long term lending would become more expensive, the business lending structure may be forced to change, reducing the availability of credit in some circumstance or resulting in shortening the maturities of the loans and loan commitments.

Question 21: What kind of incentives could help promote better long-term shareholder engagement?

Answer – Greater long-term shareholder engagement would mean, above all, policies that provide incentives to take part in Shareholders' Meetings so that the Assembly can actually perform its statutory role in policy-making as company law assigns through its power to appoint directors and set their fees.

Greater engagement is encouraged through reduction in costs and simplifying procedures for taking part in meetings, such as, for example, the use of IT systems for taking part in meetings and voting.

Current regulations pursuing these objectives, felt to be a primary value in sound corporate governance - also through EU guidelines - are well advanced and offer companies a number of devices to encourage active participation in meetings. Rather than intervening with new instruments, we

believe it would be appropriate to leave businesses the time to absorb the current ones and take advantage of all the opportunities they offer.

Question 22: How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?

Answer – The regulations that currently govern conflicts of interest, remuneration and bonus policies and the composition of the board of directors are already advanced. Other interventions are outlined in the Action Plan: European company law and corporate governance, including incentive policies for small shareholders to participate and in the CRD 4 packet.

The legislative and regulatory framework already indicates its clear favour for remuneration criteria that encourage long-term investments: nevertheless, the legislation is fairly recent and sometimes very sophisticated (just consider the provisions on remuneration), or those that are still in the process of being issued.

Before intervening again with the governing regulations and running the risk of creating regulatory overkill, we believe that it would be appropriate to leave the market the time it needs to assimilate the current regulations, applying them in line with the principles of law expressed at a European Union level.

Question 23: Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?

Answer – If the question intends to raise a query about whether it is appropriate to revisit the concept of fiduciary duty in the context of long-term financing, by forcing shareholders through regulations to pursue long-term investments, the following comments are needed.

According to the contractual conception of joint-stock company, the administration of the company depends on the shareholders in the assembly, who attribute the fiduciary assignment to the directors to fulfil the obligations that derive from their fiduciary duty. The shareholders, however, are the first interest holders and it is their duty to define management policies and to assess the management.

The fiduciary relationship between the directors, the assembly and the shareholders is founded on the same principles that characterise the trust that exists in relationships between a mandate holder and a mandator, which consist of an obligation of loyalty to the interests of the shareholders, to be pursued according to criteria of correctness and diligence, whatever the nature of the assignment.

In this perspective, the regulatory provision relating to directors imposing on them the pursuit of long-term interests would become a limitation on the powers of the assembly to define the scope of the mandate and would attribute to directors the power to pursue other or different interests to those defined by the assembly: a conclusion that is incompatible with the principles of company law.

In our opinion it is necessary to keep separate the issue relating to the definition of fiduciary duty which forces directors to fulfil their assignment with diligence: an area in which it is deemed inappropriate to intervene, from that of the definition of the contents of the assignment (scope of the mandate), referred to the independence of the shareholders. On this level it may be appropriate through the recognition of incentives to intervene in the definition of investment policies that pursue value over a long period.

Question 24: To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?

Answer – A greater integration of financial and non-financial information would encourage investors to better understand the business and its potential future performance and contribute to better investment decision-making. Not only investors but also creditors, employees and other interested parties may benefit from such integration.

Disclosure of specific risks and mitigation strategies would show investors that an entity is proactively responding to its' external environment. Disclosure of an entity's activities, operating models and strategic direction would provide useful information on how an entity intends to generate business and value in the future.

However non-financial information should only be included in the annual accounts if material and relevant to understand company's financial and earnings position and development. Any additional information should be presented in a sustainability report or similar document to avoid that company's annual or consolidated accounts are overloaded with an increasing number of disclosures with no direct relevance to its finances.

The paper also notes that quarterly reporting may push market participants to focus on short term results. The ABI believes it is unlikely that a change in the law or listing rules would change established behavior or investor demands for information.

Italian banks are active in the voluntary processes of integration of financial and non-financial information, also and above all through the processing of sustainability reports, an instrument with which an enterprise discloses the actions undertaken by its organisation in order to improve its economic,

environmental and social performances, the results of such actions and its future strategies for improvement.

This kind of reporting provides an opportunity to deal with non-financial aspects, to improve the strategic allocation of resources, reduce costs, improve the monitoring of risks of varied nature, including those relating to reputation and identify business opportunities by promoting greater transparency in its disclosures to the market.

During 2012 in Italy, banks representing 75% of total assets in the system published a sustainability report (ABI figures as at 31 December 2011).

ABI provides support to banks in using the most up-to-date international standards of non-financial reporting with the aim of supporting the comparability of non-financial information and favouring further diffusion of sustainability reporting among banks.

For example, the use of the international guidelines of the Global Reporting Initiative (GRI) is extremely widespread within the Italian banking sector: 52% of banks which publish sustainability reports use the GRI Guidelines.

Considering the European Commission recent actions aimed at introducing the obligation to make disclosures on policies, risks and results concerning issues on environmental, social and labour-related responsibility, the compliance with human rights, the fight against corruption and in favour of diversity in boards of directors, ABI recognises the needs of operators to describe and make the most of all the business components which go towards determining the overall value that an enterprise creates; the need for such elements to be recognised by the market and by investors; the importance of simplifying their reporting and making it more effective.

Question 26: What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

Answer – In the light of the current economic situation and considering the future coming into force of Basel 3, it would be appropriate to review the current European prudential regulations regarding stakes in private equity that banks can hold so as to reinforce the recapitalisation of operationally valid enterprises but which have a deficit in their equity structure.

The European Directive on Capital requirements for exposure in private equity instruments assumes importance for banks since they are often among the leading subscribers of private equity funds, as well as being direct investors in enterprise equity. A kind of treatment that penalises investors in undertaking these investments makes them less attractive to banks and consequently reduces the financial resources intended at the

birth and development of enterprises with negative effects on the economy in general.

For private equity exposures, that are direct or indirect (through specialised funds), the concept of "a sufficiently-diversified portfolio", assumes particular importance, since on the basis of the circumstances that the investments are or are not sufficiently-diversified affects the treatment outlined in the Basel regulations. In particular, with reference to the IRB approach, one moves from a weighting of 370% to a weighting of 190% if the investments are made within the scope of a sufficiently-diversified portfolio. The directive on capital requirements, however, does not provide a definition of this concept, whereas it would, on the other hand, be appropriate to provide such a definition also to avoid regulatory arbitrage situations between different European countries.

Alongside the initiatives that the Commission has identified and is pursuing (as confirmed in the Green Paper) on the subject of SME financing, the time is right to prepare European legislation that governs the phenomenon of raising equity through on-line portals, the so-called crowdfunding. The category of innovative start-ups may tendentially be included within the panorama of new enterprises and in order to provide incentives for their development, Italy is leading the way on the international stage by providing itself with a piece of regulations regarding the so-called equity crowdfunding through on-line portals. We believe that general and EU regulations for the phenomenon of equity crowdfunding could provide a thrust in growth of the European system, stimulating entrepreneurial initiative also between countries until a critical mass in investment offers is achieved which would generate innate mechanisms of selection and reward for the best ideas.

However, the experience in Italy is demonstrating, particularly in this case, the extent to which the definition of European regulations on crowdfunding represents a complex challenge because they would need to be weighed up and closely combined with the characteristics of the reference market.

In fact, establishing rules for equity crowdfunding through portals implies certain preliminary political choices, which consist of identifying a point of balance between the requests for protection from investors and the requests for rule simplification/exemption for the offers.

In other terms, totally waiving the traditional rules on performing investment services or inviting public savings means supporting the possibility of a reduction in the level of protection for investors, which could mean providing incentives for incorrect behaviour causing irreparable damage to the level of trust in the new market. On the other hand, applying the same rules for "traditional" investments to this new segment could become a disincentive to use these new sources for enterprise funding.

These choices regarding law and economics have implications also on the role that is attributed to the investment firms and banks, which cannot be established on a theoretical basis but needs to be weighed up through a careful analysis of the economic scenario of this potential market at a European level.

Question 27: How could securitisation instruments for SMEs be designed? What are the best ways to use securitisation in order to mobilise financial intermediaries' capital for additional lending/investments to SMEs?

Answer - The techniques for the securitisation of capital to SMEs are already advanced; in fact before 2008 they were used abundantly by financial intermediaries. Therefore, the point is not so much finding new ways of securitisation but finding possible mechanisms for injecting trust in and relaunching the ABS market. On this point, please refer to the suggestions made in reference to Q14.

4. Papers from relevant European Business Associations:

- European Banking Federation (EBF)
- European Fund and Asset Management Association (EFAMA)
- European Private Equity and Venture Capital Association (EVCA)
- Insurance Europe
- Long Term Investors’ Club (LTIC)

European Banking Federation (EBF)

European Banking Federation

Ref.: 001508-j

Brussels, 25 June 2013

Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

The Commission Green Paper on the Long-term Financing of the European Economy: the European Banking Federation response.

General remarks

The publication of the Commission's Green Paper on the long-term financing of the European economy comes at a difficult time. Europe is facing weak consumption and investment at home, and battling with strong competition abroad. The economy is in urgent need of stimulus, but new financial services' regulation is adding to the complexity and uncertainty for policy-makers and economic actors alike. The banking sector, the main source of finance for industry and households, is currently coming to terms with an array of new financial regulatory requirements, which is profoundly affecting its role. Banks have always had the traditional role of transforming short-term funding into longer term financing, and we need to ensure as part of this Green Paper review that this role is nurtured.

The European banking sector has successfully financed the European economy and economic growth for the last 50 years and more. Loans have been a cornerstone of this financing structure and should continue to be so. Companies of all sizes have requested and benefited from a relationship-based financing structure. The EBF supports the further development of a market-based financing structure in addition to bank-based financing, but notes that the financial market - anonymous as it is - is not always as effective as the Green Paper seems to imply. While it may be desirable to seek experience from other regions across the globe, it is not necessarily the case that non-bank models are more advantageous for the seeker of finance.

We are concerned about certain political and regulatory developments in Europe. A number of regulatory proposals are hampering a proper engagement of the financial sector in the real economy. Holding assets becomes expensive and pricing risks difficult. Hence, we perceive a divergence between what is justified for economic reasons, and what is proposed at political level. The European Banking Federation therefore supports the Commission's decision to launch a debate on this important issue, which necessarily touches on a wide range of legal and policy fields. As the Green Paper points out, long-term financing is central to supporting structural economic reform and a return to growth. But the EBF regrets that this strategic review is taking place only now. It would have been helpful if the possible

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cumulative consequences (including unintended effects) of the various regulatory measures had been discussed earlier. At an earlier stage, such a consultation could have had an impact on the ongoing regulatory measures. The effects on the capability of banks that are now being addressed in the Green Paper, are a reason to hold back on further regulatory measures (such as the separation of banks, the Financial Transaction Tax (FTT)) until the current measures are fully in place and show their impact.

A systemic and thorough impact analysis would be required for an accurate view of the future capacities of traditional sources of finance to be obtained. Such an overall assessment should try to capture substantial cumulative effects and embrace all relevant stakeholders, including not only banks, but also insurance companies, pension funds and the providers of financial services in general. Until such an overall assessment is available, it would be desirable for there to be a regulatory pause until the recently adopted legislation can be properly assessed.

Despite the uncertainties, the EBF here offers its views on how the EU can better face the challenge of financing growth. It focuses on the role that banks can play in supporting longer term financing needs, in face of the likely constraints on the way banks manage their businesses and interact with other economic agents. It assesses what the future may hold for traditional banking, and makes proposals for measures which may enable banks to preserve their historic contribution to economic growth and social welfare.

The regulatory environment

The crisis has shown that financial regulation and its supervision were not sufficiently focused and rigorous to prevent excesses of risk-taking. New prudential rules and the managerial lessons learned from the crisis should change banking business practices for the better, and help restore confidence in the sector.

But risk cannot – and should not – be regulated away. Traditionally banks have stood between the company or the individual and the risks which must be taken if an economy is to grow. They have been able to take on this role, while transforming short-term deposits into longer term investment loans, because they are able to engender sufficient confidence in society to be assured of raising an equivalent volume of finance over a continuing period. Moreover they possess the financial skills to generate innovative financial products, for example, to hedge risk on the capital markets, which they put at the service of their clients.

Since the crisis, the financing environment has worsened dramatically in many parts of Europe. Confidence in banks has been weakened. The Basel III supervisory framework and other targeted regulations have had, in some cases, an anticipatory effect already. Now they will take full effect. Some parts of the new regulation would, if introduced, directly handicap banks' ability to finance longer term: notably the proposed Net Stable Funding Ratio (NSFR) of the Basel rules, which would discourage maturity transformation. In turn, the Commission's proposal for the FTT in eleven EU Member States would only compound the problems posed by the regulatory overhaul underway.

It is possible to obtain indications of likely future conditions for financing the economy from observation on the front line of the banking business. In practice, it can be difficult for banks to raise new capital to

meet the higher prescribed risk weights on their assets, and to hold sufficient highly liquid assets to meet the liquidity requirements. Some have therefore begun reducing their on-balance sheet holdings of risk-weighted assets; and privileging liquid assets, which are likely to be shorter term. Domestically, the reduced supply of financing has in certain instances lead to lower risk-taking, higher collateral requirements and higher loan prices for companies.

Economic growth depends on international trade, which in turn depends on available financing, giving a critical role to finance providers. Merchandise exports account for around a third of EU GDP, and exports are expected to have been the main contributor to EU growth in 2012. This vital source of hope for Europe's economic future is currently suffering from banks' difficulties to fund a traditional business: the financing of large trade transactions requiring medium- and long-term credit.

In the discussion of the long-term financing of the European economy, these trends should be evaluated and addressed. In particular, the longer term impact of the incentives and disincentives created by the new regulation needs to be better understood.

It is essential to create an appropriate regulatory framework for banking activity and the economy as a whole. This should ensure a recovery of investor confidence, but not be constrained by legal and regulatory provisions with contradictory effects that place considerable restraints on the funding of the economy. Due to imposed deleveraging, the increasingly strict capital and liquidity requirements, the higher cost of bank loans and the deterioration in companies' economic and financial situation, banks face growing constraints. Yet banks remain crucial to the existence of a sound financial system and the development of the economy, inter alia, supporting maturity transformation.

Access to finance: the "new normal"

Banks play a vital part in distributing liquidity, accounting for around three quarters of business financing in the EU, with an outstanding stock of loans to companies of some € 5.3 trillion by end 2012, equal to one third of total bank lending to the EU economy. The huge scale of bank activity in recent years means that their deleveraging, and the squeeze on their capacity to take on new risk assets, may have already damaged growth prospects in some parts of the EU.

Today, we appear to be on the verge of a new era for banks, characterized by: rationing of risk assets; strategic choices between business models (in some cases, disadvantaging activities that are low-risk and low-return, because of the need to increase earnings and build capital); a greater focus on fee-earning services; and possibly a narrowing of the geographical horizon, as banks are being pushed towards business within national borders due to the fragmentation inherent in the new EU regulatory framework, with all its drawbacks for the real economy. In addition, there are opportunities for new players to work alongside banks, particularly in funding, although banks will remain important participants owing to their global view and technical knowledge.

For the banking industry, the challenge of the future is to make use of their capacity to commit large volumes of financial support over longer periods, as well as their skills, techniques, and global spread, in new ways, so that they continue to play a central role in financing economic activity and growth.

Maximizing banks' contribution to longer term financing needs

The crisis, and especially the policy changes that it has generated, appear likely to diminish the importance of banks in financing the economy. This is a worrying outlook, and a problem which needs to be addressed. It is clearly a priority to develop the capital markets for debt and equity. However, ***Europe will achieve greater diversity and security in sources of long-term financing, if it can encourage prudent growth in its capital markets, give banks scope to use these markets to a greater extent in managing their business, and allow banks to maintain their central role in relationship-based financing.***

Underlying the EBF's replies to Green Paper questions, on the following pages, are the recommendations and observations set out below. In the EBF's view, these points demonstrate how the flow of essential finance and financial services can be best preserved, so as to meet the longer term needs of Europe's economy.

- The policy which emerges from the Green Paper exercise should be framed so as to **make the most of the market mechanism**, subject to suitable prudential controls. There is scope to help the market to perform its traditional function of allocating capital efficiently, and more effectively. However for some of the vital issues raised in the Paper, it is not clear what regulators and legislators can do to address them. There is the risk that initiatives will introduce artificial mechanisms which may produce worse outcomes. It follows that public intervention should focus on areas of real market failure, to avoid interference with the dynamics of a healthy market.

- **Channels of liquidity should be fostered**. Banks' role as intermediary between lenders and borrowers is an essential economic function. Their skills (not least in credit assessment and monitoring), and their relationships and extensive networks, make them uniquely well-equipped, not only to originate credit, but also to accompany households and businesses longer term. Ensuring sufficient liquidity includes keeping international channels open. International competition ensures cheaper credit and greater resources at times when domestic channels are clogged.

- Against the likely regulatory background, **banks may maintain their presence as lenders better if they can limit their risk assets through the capital markets**. Here, banks are increasingly looking to reduce their balance sheets and to develop funding sources which allow them to continue to finance longer term, largely through bond and securitisation markets.

- Although not specifically outlined in the Green Paper, medium- and long-term export finance covered by Export Credit Agencies (ECA) is an important countercyclical instrument to support export-oriented corporates in Europe. This is evidenced by a robust volume of ECA cover in 2011 and 2012. The potential impact of recent regulation on the capacity of banks to maintain this long-term export finance is still considered as disadvantageous for the export-driven industrial sectors in Europe, despite several initiatives by ECAs and banks to support funding schemes.

- Banks provide essential support to SMEs, which account for the vast majority of companies and two thirds of private sector employment. Yet, they have reduced their financing activity in the longer loan terms, of over five years. Here, a number of **EU and national policy initiatives are helping to assure a longer term horizon for financing**, notably through the facilities of the European Investment Bank (EIB) Group, and the targeted use of EU programme guarantees to complement market resources. There are already good models of public-private partnerships – such as the EIB Project Bonds - which can unlock private market resources for the longer term, riskier financing. The drive to promote the financial knowledge and expertise of borrowers is another important plank among the measures outlined in the SME Action Plan. Banks are closely associated with these steps to promote access to finance, and are putting their weight behind the efforts to add to the range of financing instruments, for example through securitisation.

- In the context of banks' lending to industry, **policy-makers must find a balance between promoting growth and jobs, and the temptation to over-regulate** the commercial financial market. Some of the ideas put forward by policy-makers (for example, concerning bank transparency requirements in credit evaluation) could imply additional costs and risks for banks. These could in turn deter credit provision, rather than encourage it.

- The potential impact of the proposed Basel liquidity requirements, for minimum levels of so-called stable funding which banks must hold (the Liquidity Coverage and Net Stable Funding Ratios), and the narrow definition of qualifying financing, need to be fully considered. If implemented in their current form, they could further lower demand for bank debt and increase competition for deposits, which is expected to raise longer term borrowing costs for the wider economy.[1]

- **Policy will have to accommodate the rich diversity of conditions in the EU**. A monetary union built on a foundation of cohesion, convergence and solidarity is supposed to have relatively homogeneous funding conditions in all Member States. Harmonisation is beneficial and to be encouraged in some areas, particularly on the supply side: to facilitate the flow of liquidity within and between the national financial markets. However, policy directed at the demand side

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[1] See McKinsey study, which finds that European banks face a EUR 1.2 trillion (US$1.6 trillion) shortfall in funding as regulators implement stricter liquidity rules. That deficit will probably grow by 200 billion euros by 2018 based on estimates for deposits and economic growth. It further estimates that the European corporate bond market would have to triple from about 900 billion Euros to a size comparable to those of the US and UK to close the gap.

will be refracted through individuals and companies, which differ considerably in their scale, conditions, relationships and practices. In this context, policy may need to be flexible, if it is to be effective.

- **The dimension of risk - particularly investor risk - must be borne in mind**. Longer term horizons imply higher risk. Alternative providers of finance may be asked to take a higher risk than banks, whether through securitisation, corporate bonds, pension fund investments or crowd funding. It is therefore essential to reinforce regulation and supervision of the shadow banking system. In addition, the dependence on ratings (a procyclical component) should be reviewed, as it poses a substantial obstacle to funding, thereby exacerbating the recessionary cycle.

- **Banks need to be able to take normal strategic business decisions**, allowing them to structure their activities to take advantage of product synergies and maximize effectiveness. Otherwise they may be less profitable; more vulnerable, because unable to spread risks between business lines; and lose competitiveness globally. The proposals in the report from the High-level Expert Group on reforming the structure of the EU banking sector (the "Liikanen report"), to enforce the separation of proprietary trading activities from other significant trading activities, could backfire on the economy. They could hamper banks' ability to manage their businesses better (notably through diversification), and to offer more sophisticated services, particularly for companies operating internationally.

- The **EU economy cannot be viewed apart from the global backdrop**. Its economic and political capital will depend partly on how it compares and competes with other economic blocks. Measures such as the Financial Transaction Tax (FTT) will tend to reduce EU market share, other things being equal. The Liikanen proposals referred to above would reduce the competitiveness of Europe's financial sector on international markets. Multinational corporate clients would be encouraged to turn to fully flexible, multifaceted financial providers which are subject to less interventionist regimes. Subject to appropriate regulation and supervision, the **skills and techniques associated with more complex financial products, such as derivatives, should be preserved**, as they can reduce the risks faced by industry, particularly on international markets.

- **External financing is crucial**: the capacity of the economy to provide the financing for long-term investment also depends on its ability to attract and retain foreign direct investment (FDI). To enable international capital flows to continue, both into and out of the EU, EU legislators should scrutinize regulatory projects with regard to whether free flow of capital and market access remain assured as far as possible. The MiFID/MIFIR proposals certainly deserve some consideration and amendment in this respect. In particular, MiFID/MIFIR needs to balance the need for access to international markets with maintaining high standards of investor protection and market integrity within the EU. Simultaneously, MIFID/MIFIR should not prevent EU investors from receiving services or activities from third country firms, or EU issuers from raising capital in third countries.

The following pages provide replies to those of the Green Paper's questions which are considered the most relevant for the banking industry. More detailed background to these comments can be obtained from the EBF Secretariat.

Brussels, June 2013.

ANNEX: EBF responses to the questions put in the Green Paper

1. Do you agree with the analysis set out above regarding the supply and characteristics of long-term financing?

EBF members have some doubts about the terminology used, which seems to contrast "financial capital" with "productive capital". Some explanation of terms should be provided.

The Green Paper assumes that households "generally prefer liquidity and easy redemption. Stability is preferred and risk-aversion is now widespread". The financial crisis has no doubt affected investment choices. But under normal economic conditions, households are often ready to take on longer term, riskier assets. Tapping into other sources of savings for financing may create new risks, in terms of risk-taking by new actors who could then be vulnerable in case of failure of a project.

We believe it is important to understand that many institutional investors do not have the capacity to be a good funding partner for SMEs or other private projects. Their interest is mostly in the return on their investments and not in helping the corporate with their business.

2. Do you have a view on the most appropriate definition of long-term financing?

A rigid definition is best avoided. The expression encompasses the expectation of investing so as to generate lasting benefit, and - most often - the assurance of funds or funding over a lengthy horizon. A wide range of transactions could be covered: healthcare, start-ups, social projects, and/or large infrastructure projects such as dams and power plants.

Long-term finance is a theoretical concept because it varies on the basis of the existing economic and financial context. Highly volatile frameworks from an institutional, political, economic or financial standpoint will tend to create pressure for a reduction in the maturity of long-term finance. The focus needs to change from long-term finance to long-term investment and ensure that there is confidence in that investment.

3. Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

The banking sector can be expected to remain central to the channelling of financing to long-term investments, given its prime functions of intermediation and liquidity transformation. However banks' activities will evolve. The new model is likely to see banks as lenders (supported by greater recourse to capital market products such as covered bonds and securitisation to manage balance sheets and tap alternative funding sources); and as facilitators, for corporate bond issuance and the creation of new sources of liquidity based on good quality (perhaps alternative) assets. They can play a central role in enabling institutions with longer term liabilities, such as pension funds, to invest in assets of a similar tenor.

In assessing the scale of banks' capacity to contribute to meeting the economy's longer term financing needs, a thorough assessment needs to be made of the possible consequences of the Basel Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). The EBF welcomes the provision for a monitoring period for the LCR and NSFR, with a view to expanding the range of eligible liquid assets and long-term stable funding. We hope the review will further facilitate the selection of liquid assets for banks from an otherwise rather limited pool of cash, sovereign bonds and central bank reserves; while also allowing banks to diversify their buffer, and thereby avoiding risk concentrations in a few limited asset classes.

Also critical for banks will be the outflow rates which prescribe the amount of the short-term and long-term funding requirements. It is hoped that further analysis of outflow factors will bring these in line with actual experience during the recent financial crisis, and thereby provide for a less conservative calculation of the LCR and NSFR. Some banks already meet the revised LCR standard put forward by the Basel Committee in January 2013. But some others will need more flexibility to adapt their funding and business models, while alleviating the restrictions, in order to maintain lending to their customers during this period of economic weakness.

4. *How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?*

Much care and attention needs to be given to the interplay between public and private financing sources, and to protection of market mechanisms. Government accounts for around a third of long-term investment in most countries, while the development banks can be very effective at filling market gaps, notably in the longer term financing. Coordination between these public sources (national and European) must be maximized to ensure coherence and effectiveness.

So far the financial instruments under the EU budget have operated well, but as the programmes become more complex (for example with the linkages between the COSME and Horizon 2020 initiatives, scheduled to become operational in 2014) there is a risk of confusion and reduced effectiveness at recipient level. Closer collaboration between the stakeholders – including private banks – should improve investment outcomes. It is worth noting that in many parts of Europe the system for funding of SMEs is working well.

5. *Are there other public policy tools and frameworks that can support the financing of long-term investment?*

a) Financing of international trade

Besides national and multilateral development banks, government-backed export credit insurance plays an important role when it comes to guaranteeing long-term finance. Against a background of debt-laden public authorities and private consumers, industry's ability to tap foreign demand is the main hope for

economic recovery. In 2012, net exports were the sole component of demand to make a positive contribution to GDP growth in the EU, contributing 1.1% while overall growth fell by -0.3% (Commission Spring 2013 European Economy Forecast)[2]. They are a vital part of European governments' efforts to restore economic growth and increase employment in the EU. The Commission has estimated that, for every 10 jobs created in industry, between 6 and 20 new jobs are created in the rest of the economy.

Most trade needs financing, particularly the longer term international contracts. To ensure that exporters obtain the necessary finance to compete on international export markets, many governments provide, through their Export Credit Agencies (ECAs), guarantees and insurance to cover the political and economic risks faced by financial intermediaries. ECAs' activities in medium- and long-term export credit usually support capital goods producers (e.g. for renewable energy and infrastructure projects). They also support SMEs, which are often suppliers and sub-contractors to the bigger companies. From a banking perspective, export credit insurance frees up capital in banks, and thus lowers costs.

This long-standing framework of support for larger, longer term financing has become more important since the crisis. At the same time, many European banks have been required to deleverage, reducing risk assets. To be able to continue providing export finance, they are therefore working to include institutional investors in government-backed export credit finance, with the job of credit management remaining in their own hands. At the same time, both investors and supervisors still need to know and understand more about the character of this kind of finance and how it works.

Because of the long-term character of export credit, refinancing such credit is a key task of banks. At the height of the financial crisis, refinancing, particularly in US dollars, posed a challenge. The situation has improved significantly since then. In a good number of countries, the authorities are adapting the form of their support to facilitate banks' access to capital markets for funding: for example, by offering securitisation guarantees in addition to the traditional insurance or guarantee. Such policy changes are welcome.[3]

A further practical step which could help to preserve this business line would be for the European Central Bank and other EU central banks to allow ECA-supported export credit to be eligible under their refinancing windows. This short-term refinancing could not be considered a source of funding, but it would enhance the liquidity of export credits according to the Liquidity Coverage Ratio of the EU's Capital Requirements Directive IV, and render those assets more attractive for banks' internal balance sheet management.

b) Finance for industry

At the level of industry, banks work closely with the European Investment Bank (EIB) in providing finance for companies of different sizes. Here, the high level of collateral required for loans granted to companies by the EIB through the banks, limits their benefits from the financial perspective. There is a tension between the political will to use the EIB as a principal vehicle for promoting economic recovery; and the defence of its institutional status, (particularly in terms of ratings). This is reducing its impact on the ground.

[2] http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee2_en.pdf

[3] See EBF position, 27th May 2013: "Funding conditions in export credit markets: 2013 edition" on www.ebf-fbe.eu.

Nevertheless, the EIB has taken an active and innovative approach in developing tools, such as the Loan for SMEs and the Project Bond, as a catalyst for private market funding. The EU is working with private sector financing institutions such as banks in fostering research and innovation, and in meeting the needs of SMEs in particular. The continuation of these programmes, and a continuing readiness to innovate in terms of EU financing instruments, should work well in filling gaps left by the private market.

Measures to reduce late payments and facilitate the financing of receivables should enable companies to meet working capital needs more easily, freeing them to address longer term investment and financing needs.

> *6. To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?*

The historical, countercyclical role of institutional investors such as pension funds and insurance company funds has changed significantly in recent years, due to regulatory and accounting changes which resulted in an excessive focus on the short term. Nevertheless, the liquidity held by such institutional investors can play a crucial role in reviving the flow of funds into the economy. While the business profiles of these institutions may not allow them to play a major part directly in the financing of the economy, banks and other financial institutions can fill the gap through their skills and experience in financial intermediation. If institutional investors are to play a role in the credit market, it is important that they should be able to manage credits in a way that could benefit both themselves and the companies needing the funding.

> *7. How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?*

> *8. What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?*

The creation of pooled investment mechanisms, such as investment funds aimed at the long term, can perform an important complementary function in long-term funding by diversifying the investor base. There are, however, potential obstacles to the creation of these mechanisms, such as: i) lack of long-term political consensus; ii) regulatory instability; iii) lack of harmonisation of taxation regimes; iv) different stages of development of capital markets; and v) inefficiency in some judicial systems.

Securitisation plays a central part in the EU banking sector. Unlike banks in the USA, European banks cannot transfer their risks to government sponsored entities (GSE). Instead, European banks use securitisation as virtually the only vehicle to transfer risk from their balance sheets and leave room for

new lending. For this reason, it is imperative that policy makers pay heed to the consequences that regulatory proposals could have for the European-originated securitisation market.

The proposal of the Basel Committee for a new securitisation framework is an opportunity to tackle the problems associated with structured finance products without unnecessarily reducing the business sense of securitisation. The EBF proposes that as a matter of principle the regulatory treatment of securitisation instruments should be equivalent to that of the underlying pool of assets.

In this vein, the Prime Collateralised Securities initiative is intended to reinforce the asset-backed securities market in Europe as a key element in achieving sustainable economic growth in the region.

9. *What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?*

The national financial markets are at very different stages of development. There is room for greater uniformity, which would enhance liquidity and depth.

10. *Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?*

The cumulative impact of the regulatory reform has been subject to multiple studies from different sources and angles. However the response to the question remains unclear.

The Macroeconomic Assessment Group led by the Basel Committee on Banking Supervision (BCBS) published the results of a number of impact assessments led by the BCBS to estimate the impact on growth of a 1% increase in the capital requirements for banks. The study provided a lot of information, nonetheless, some key questions remained unanswered: will the impact grow at higher rates (e.g. exponentially) so long as the overall capital requirement is increased? Will the regulation and its interplays hit harder certain investments (e.g. long-term investment)?

The key question as to the overall impact of the regulation is how inelastic the supply curve for bank capital and long-term bank liabilities will become. The banking sector cannot be studied in an isolated fashion due to the fact that it competes with other sectors for funding and capital. The capacity of banks to sustain long-term investment on their balance sheets will be determined by the extent to which banks are able to deliver return to their investors, i.e. a competitive return on investment (RoE).

Increasing the proportion of short-maturity lending has been pointed out in some studies as a factor that will reduce funding costs. Banks will find a way to ease compliance by offering more revolving loans rather than long-term commitments.

Another restrictive factor is the intensive use of “balance-sheet space” required by long-term loans. Inevitably, the safer regulatory framework pushes up the cost of holdings on the balance sheet and that increase becomes quasi permanent in the case of long-term investment. As banks are forced to adjust

their business models, long-term holdings that consume a big chunk of scarcer and costlier balance-sheet would be expected to become unattractive at current spreads.

In summary, there are grounds for thinking that banks have to reduce exposure to asset classes that account for a large share of risk-weighted-assets (RWA) with a less than proportional contribution to the RoE. Long-term investment has all the elements to be an unattractive asset class in the portfolio mix. Risk transfer, i.e. securitisation, should be the answer. Therefore, a liquid securitisation market is essential to alleviate the pressure exerted by the safer regulatory landscape.

In order to **reduce the cumulative effects of financial regulation** to restore banks' role in long-term financing, the following proposals/considerations should be taken into account.

1. The Commission has conducted impact studies for each proposal it has presented. There is, however, so far no impact study for the cumulative effects of the comprehensive regulations. Such a study is essential for restoring banks' role in long-term financing, and needs to be conducted in a transparent manner.

2. The proposals in the so-called Liikanen report would further increase funding requirements and increase funding cost in addition to all the other regulations. The Commission is advised to take a cautious approach going forward with new proposals such as the recommendations in this report. It would be advisable that the impact study on the cumulative effects of the comprehensive regulations is carried out in parallel with a separate impact study for the add-on effect of the Liikanen proposal. The Liikanen part should consider the role of market making, hedging, etc. in economic growth as well as activities for regulatory purpose or within treasury functions.

3. On the demand side, Solvency II is likely to deter insurance companies from investing in bank debt. It would be advisable to consider the combined effect of banking regulations and insurance company regulation in the assessment of the effect on the long-term financing market.

4. The use of derivatives for legitimate hedging purposes is a central part of corporate financing notably long-term transactions. Additional capital requirements like the credit valuation adjustment (CVA), if applied to non-financial institutions, could only have a pernicious effect in corporate long-term lending as hedging is an integral part of these transactions. The CVA capital requirement has rightly been exempted for non-financial counterparties in the capital requirements regulation as approved by the Parliament on 16 April 2013.

5. The regulation on the Net Stable Funding Ratio (NSFR) has a particularly large impact on bank lending with longer maturity as it requires more costly stable financing. NSFR goes against the fundamental role of banks in liquidity/maturity transformation. In this regard, the EBF fully supports the Commission's approach to assess the impact of this regulation for bank lending with longer maturities.

6. The proposed Financial Transaction Tax (FTT[4]), in 11 Eurozone countries is a major threat to long-term growth in Europe. Taxing transactions in vital financial instruments would have a severe impact

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[4] On 28 September 2011 the European Commission adopted a proposal for a Council Directive on a common system of financial transaction tax, which was renewed by the Commission on 14 February 2013 when a proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax was adopted.

on long-term financing. We would here point specifically to the bond market, which is essential to financing of corporates and states. A transaction tax would erase a major part of the secondary market for bonds, harming liquidity and making it a more expensive source of funding.

7. Crisis management is a very important piece of regulation. It provides a clearly defined framework for how crisis should be managed for banks. Having said this, we have concerns for some parts of the proposal considering its consequences for long-term financing.

    a. The present structure of banking groups has benefited economies and consumers by providing cost-efficient banking products including long-term financing products. It is vital that local regulators do not implement bank resolution plans in such a way to force banking groups to change their present group structure to a structure of ring-fencing at legal entity levels.
    b. In order for long-term financing to benefit from the present group structure, minimum requirements for bail-in instruments should be applicable only at the group level, and not also at the legal entity level.
    c. Entry into force of bail-in already in 2015 will accumulate the negative effect of increased funding costs for banks, which would affect banks' role in long-term financing negatively. It is strongly advised to postpone this, until the effects of the rules entering into force in 2014 are known.

11. How could capital market financing of long-term investment be improved in Europe?

1. Promoting long-term savings, specifically in equities

It is essential to have incentives for long-term savings and equity. However, the Green Paper misses a key investor perspective; namely, there is always a risk-return equation to be solved. This means that the higher the perceived risk, the higher the expected return; longer horizons are by definition riskier than short-term ones. Consequently, taxes on savings should be revised to take account of this perspective and reflect the following accordingly:

- successive taxes on capital are harmful to savings, investment and, ultimately, growth;
- tax breaks should be made more attractive for long-term, higher-risk vehicles;
- in the current context of low-to-no yield, for many vehicles, taxes become a deciding factor.

2. Designing long-term financing products that are adapted to long-term investors

The EBF believes that prudent growth of new bond, securitisation, and equity markets, adequately overseen and supervised, must be part of the solution to the long-term finance problem.

a) Inventing new securitisation formulas

Re-establishing securitisation transactions (possibly in the form of secured bonds) that are less opaque and better secured could give certain flexibility back to the management of bank balance sheets, particularly for the liquidity ratio at over one year. Specifically, it would concern bank loans to businesses, but also financing of smaller-scale infrastructure projects that have similarities.

b) Financing infrastructure

With long-term financing so heavily penalised under Basel III, bank financing of infrastructure will be reduced, particularly for periods in excess of five-to-seven-years. Therefore it is important to develop effective formulas for financing or refinancing these infrastructures via the bond market. These long-term, tangible, safe assets, as long as the technical and legal conditions for financing are met, lend themselves, *a priori,* rather well to insurers' long-term savings and pension fund management needs. It is conceivable that the EIB could play a key role in this, even if national solutions must also be sought.

c) Smarter regulation

Retail investors and private banks are becoming a more important source of liquidity. However, denominations for transactions tend to be too large for retail investors. The EU Prospectus Directive requires much more detailed documentation if a transaction targets retail investors. Retail compliant documentation significantly increases the legal costs of a transaction, up to as much as 30%, which of course does not encourage small denominations. This means deals have a minimum denomination of € 100,000, a high threshold when considering the retail investors.

Simplification of the prospectus requirements for retail documentation would be a very welcome development that would expand the possibilities for broadening the investor base as well as giving a chance to smaller corporates that do not have access to the international capital market to tap it. Indeed the bond financing of innovative young businesses and SMEs/mid-size companies should be promoted.

Finally, for long-term investors, it is important that future prudential and accounting standards do not penalise investment in equities, corporate bonds and infrastructure.

3. Keeping international channels open

The capacity of the economy to provide the financing for long-term investment also depends on its ability to attract and retain foreign direct investments (FDI). To enable international capital flows to continue, both into and out of the EU, EU legislators should scrutinize regulatory projects with regard to whether free flow of capital and market access remain assured as far as possible. The MiFID/MIFIR proposals certainly deserve some consideration and amendment in this respect. In particular, MiFID/MIFIR needs to balance the need for access to international markets with maintaining high standards of investor protection and market integrity within the EU. Simultaneously, MIFID/MIFIR should not prevent EU investors from receiving services or activities from third country firms, or EU issuers from raising capital in third countries.

> *12. How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?*

There are many forces contributing to the widening of the “equity gap” in Europe, namely: ageing populations, the shift to defined-contribution retirement plans, the retreat from stocks in reaction to low returns and high volatility, and regulatory changes.

Nonetheless, the Green Paper fails to mention many of the trends that currently constrain the supply of equity financing.

The cost of regulation and the accumulation of various pieces of regulation that do not fit well together is a huge burden for financial actors, but mostly because of the indirect consequences for the general economy. In this regard, it is vital that MiFID II, currently still under negotiation, should enhance the ability of capital markets to finance long-term investments.

Moreover, the tax environment and subsequently the cost of financing transactions could be negatively affected by the implementation of the proposed Financial Transaction Tax (FTT). Given the wide range of financial transactions falling under the proposed FTT, the cost of financing will increase. Financing through capital markets will become more expensive even where primary market transactions fall outside the scope. Lower liquidity and more costly secondary market transactions will presumably raise the return expectations of investors. Borrowers in bank financing transactions will need to cope with raised costs for risk management instruments, such as interest rate and foreign exchange hedges, which will become more expensive in the FTT area.

In addition, implementation of the FTT in only some of the Member States (e.g. Member States participating in the enhanced cooperation) will result in different conditions for corporates in different Member States. Equally, implementing the FTT in the EU would result in disadvantages for EU corporates on the global scene.

The impact of legislative initiatives is therefore very considerable and we believe that no one has presented an overview of where and how the various legislative initiatives interact/conflict with each other. Such an overview would be a very useful tool to identify exactly where further initiatives might be needed.

13. What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?

The EBF would like to highlight the importance of creating a single, harmonised framework for covered bonds in the EU: considering both the covered bonds’ resilience in current challenging market conditions; and the fact that, under the CRD IV addendum, covered bonds traded on transparent markets with an ongoing turnover may be considered assets of extremely high quality and credit liquidity (therefore category 1 in the Liquidity Coverage Ratio).

Moreover, a harmonised framework for covered bonds would promote the stability and marketability of the product. It would enable investors to focus on the underlying issuer’s credit and collateral within the pool rather than trying to understand the differing frameworks across Europe. Nonetheless, harmonisation must not take place on the level of the lowest common denominator, and standards for underlying credit quality cannot be sacrificed.

While the EBF believes that it is a good idea to harmonise covered bonds in a European framework, this may prove difficult because of the interdependence between many different pieces of legislation. For example, most covered bond frameworks are influenced heavily by the insolvency/bankruptcy rules within that jurisdiction. Achieving harmonisation will be highly problematic.

Some elements that should be included in a future harmonised framework include asset eligibility (credit quality, average maturity of loans), asset pool monitoring requirements and procedures regarding the assets in the event of the issuer's bankruptcy. At the very least, the aim should be to have minimum requirements in some of the key areas on which investors focus. These areas could include:

- eligible assets including substitution assets;
- loan-to-value ratios – calculation and thresholds;
- minimum over-collateralisation requirements;
- regular valuation of assets using recognized indices;
- external monitoring; and
- asset-liability management.

14. How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?

The EBF would like to stress the importance of securitisation as an integral part of banks' funding, supporting the flow of credit to the wider economy and being central to the functioning of the European financial system. Re-establishing securitisation transactions should help identify new sources of long-term financing. Provided that they are subject to supervision and appropriate rules of transparency of information, these markets could help financial institutions to release capital which could then be used for additional loans or be allocated to the management of risk. While a number of areas of the securitisation markets are already under rehabilitation, some steps remain to be undertaken.

In this context, it is of great concern that the proposals of the Basel Committee on Banking Supervision (BCBS) on revisions to the securitisation framework could lead to a slowdown of the revival of the securitisation market because of higher capital requirements especially for senior positions. For this reason and in addition to the market-based initiatives (True Sale International (TSI) Prime Collateralised Securities label) a base for the revival of securitisation on the regulatory level should also be created. In the EBF's view, securitisation for the real economy market should not be treated more punitively in a regulatory sense than other forms of financing for the real economy.

Securitisation vehicles need a sponsor in the form of a financial intermediary. As stated in the EBF's response to the BCBS consultation on revisions to the Basel Securitisation Framework[5], we hope for better co-ordination of regulatory processes around securitisation, including in particular the Basel rules, as well as the insurance industry and the effects of Solvency II.

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[5] EBF final response to the BCBS consultation on revisions to the Basel Securitisation Framework http://www.bis.org/publ/bcbs236/europeanbanking.pdf

One benefit of term securitisations is that they typically offer a matched funding of the securitised assets, provided of course that there are end-investors. Many of the end-investors will be covered by Solvency II, which in the current draft form will penalise the holding of highly rated securitisations, especially those with longer maturities. We do not think that capital allocation under the current draft of Solvency II reflects the relative risk of the spectrum of potential investments and securities. The current regulatory uncertainty makes end-investors refrain from securitisations and longer terms even if they would in fact want to make such investments based on relative return.

Another area of indirect impact on term and stability is the current debate on asset encumbrance of financial institutions as a result of covered bonds, repos, swap, securitisations and other products. Securitisation has the benefit of 'locking in' the encumbrance level at the time of issuance, which means that there is limited contingent encumbrance.

15. What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?

Governments should look at attracting long-term investment through debt and equity as befits their national conditions. In an EU context, the free flow of funds into capital markets should help to erode distortions.

See also comments under question 11, part 1.

16. What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?

The question assumes that distortion should be removed between debt and equity. This assumption should be challenged: debt and equity are of a different nature (whereas equity represents an investment in a company and its business, a cash loan is a service remunerated with a pre-agreed interest). A different legal, accounting and tax treatment is justified.

Over the recent years, there has been a tendency in the EU and around the world to strengthen the "thin capitalization rules", i.e. anti-abuse measures limiting the tax allowance for interest payments under certain conditions. In the EBF's view, such measures render the financing of companies more costly and are inconsistent with the aim to enhance long-term financing.

In order to strengthen the equity structure (fundamentally of a long-term nature), some countries such as Italy and Belgium have opted for the tax concept of "Allowance for Corporate Equity", which basically allows tax deductibility of a portion of the increase of capital. This kind of measure responds more appropriately to the current need to enhance long-term financing.

> *17. What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?*

Any investment is a trade-off between expected return (financial, social or other) and risks. Investors require an incentive, and the longer their investment is immobilised the higher the return expected. The issue is then how to ensure -, on the basis of a level playing field with other investment opportunities - that an investor will be more inclined to freeze money for the long haul, over short time horizons, against a background of numerous opportunities to earn a "safe" return in liquid instruments. The Green Paper itself does not offer any convincing arguments.

From a retail investor's perspective, exit options are of paramount importance. Thus, perhaps counter-intuitively, ensuring liquidity gates or options post-investment, together with an enhanced participation to performance mechanism, may be the best tool to help attract investors. This category of investors may be faced with a sudden, unexpected need for money, and may be unable to sell hard assets for urgent cash needs. A liquid post-investment market and enhanced return will be attractive for all investors.

If tax incentives are intended to have the desired effects on long-term savings, investors have to be sure that incentives are going to last for the duration of the investment. Changes in taxation rates or the elimination or reduction of exemptions with no transitional schemes (and even retroactively) have harmful effects on long-term savings. It is also important to correct the current situation of heavily taxing savings in which people who are saving now for later use are penalised, and foster a real difference in the taxation of short- and long-term savings.

> *18. Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities?*

> *19. Would deeper tax coordination in the EU support the financing of long-term investment?*

> *20. To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?*

Financial reporting should provide information for investors, which is useful to their economic decisions. To assist investors, financial reporting should be transparent, and should reflect the effects of economic risks while avoiding introducing artificial volatility as a result of accounting requirements.

Fair value accounting provides an appropriate accounting base for financial instruments held for trading purposes or otherwise managed on a fair value basis within the business. When the underlying strategy is to draw a benefit from short-term variations in the value of the instruments, and where the entity is actively engaging in opening and closing market risk positions, fair value is appropriate, as cash flows that can be generated are mainly determined by the prevailing terms and rates on the financial markets. It also predicts the ability of the entity to take advantage of opportunities or to react to adverse situations.

In other situations, for example, banks' loan books, fair value information can be usefully disclosed, but recognising fair values in the financial statements makes it more difficult for users to understand net margin and loan losses, which are widely used measures of financial performance. The change in the value of net assets that would reflect the market's perception, for portfolios that are not traded, would not reflect the cash flow income that will be achieved in practice. If the instrument is held for use in the business to generate cash flows earned on an ongoing basis over a certain period, and where there is no intention to profit from the short-term market movements*, **amortized cost*** provides more appropriate measurement basis. Only information that will assist in understanding the timing of the potential cash flows, credit risk and probability of default will be relevant and useful for the users.

Financial reporting must reflect the business model and avoid introducing artificial volatility. There are increasing calls for disclosure: to explain more effectively an entity's business model in terms of how the entity creates, delivers, and captures value; and the link between the business model, its risks and how they and the results are managed, as reflected in the financial reporting.

Where fair value introduces volatility that does not reflect the economic risks or is not considered to provide useful information, the confidence in the reporting is reduced. A disconnect between the actual business model and the accounting could undermine the quality of financial statements and the ability of financial reporting to explain the results (increasingly being demanded by users). The financial statements become harder to interpret, increasing the costs of analysing the financial information and decreasing the company's attractiveness to investors.

While ***IFRS 9*** refers to the entity's business model as part of the criteria for classifying financial instruments, its impact will need to be considered carefully. It may, inadvertently, introduce more fair value accounting that does not in fact reflect the business model. For example, it would require that most equities and certain debt securities (those which do not meet the "solely payment of principal and interest" test) be measured at fair value through profit or loss, in contrast to ***IAS 39***. While it would also take fair value movements related to own credit out of profit or loss, overall the transition to IFRS 9 could make financial reporting more difficult to interpret, if the business model in terms of IFRS 9 does not reflect how the entity operates in practice.

If designed in a way that does not reflect the economic substance of financial transactions, changes to the accounting framework may also result in structural changes to business or investor behaviour. The EBF is indeed concerned about the wider economic impact of the accounting requirements. For example, many debt securities issued by banks have features which require interest to be suspended if, for instance, the bank is unable to remain solvent immediately after the payment. If additional interest does not accrue on the deferred interest, the instrument will have to be fair-valued through profit and loss, which may have a negative impact on the attractiveness of investments in a bank's bonds.

There are similar concerns with contingent convertibles and bail in bonds, which are an increasing feature of the regulatory environment for banks. The EBF is concerned that the accounting requirements could have implications for the market for such instruments, and changing the instruments to meet amortized cost requirements would defeat the regulatory objectives.

Not only the use of fair value, but the economic impact of the accounting rules in broader terms should be examined; such as, for example, the new provisioning model that is currently being discussed by the accounting standard setters. The EBF is supportive of the objective to achieve a sound ***expected loss provisioning*** approach promoting more forward looking provisioning through timely identification and recognition of credit losses. It must, however, be ensured that any new expected credit loss model does not disadvantage loan portfolios with longer maturities and does not discourage long-term lending, particularly at the bottom of economic cycles, and, in emerging economies. As long-term lending would become more expensive, the business lending structure may be forced to change, reducing the availability of credit in some circumstances or resulting in a shortening of maturities of the loans and loan commitments.

21. What kind of incentives could help promote better long-term shareholder engagement?

Long-term investment requires engagement, performance analysis and the financing of a stake, and this generates costs. Trading volumes and liquidity have increased, whereas average shareholding periods have dramatically decreased.

However, key components for successful and sustainable companies are the skilled, committed and dynamic board members on the one hand, and engaged and long-sighted shareholders on the other. The short-termism – which may have been indirectly motivated by past regulatory measures aiming at providing more liquidity – can dramatically affect the effectiveness of those key actors in their fundamental duties of checks and balances. As a result, deterrents need to be defined. The move to stop encouraging remuneration schemes which foster excessive risk-taking practices is a step in the right direction.

Similarly, there are a number of possible incentives that could be used for promoting long-term shareholder engagement:

- Good governance and transparency, and stricter control of remuneration practices and policies in large companies: there should be a balance of power, and effectiveness of deliberative and

executive bodies; effectiveness of audit and control systems; transparent and effective methods for determining remuneration of company executive officers; proper application of legal and tax rules; and combat against corruption and money-laundering. Moreover, there should be transparency regarding the activity and financial situation of the company, that is to say – *inter alia* – the existence, quality and certification of annual reports, so as to ensure the shareholder is confident that his/her investment is being properly controlled and run.

- Clear definition and regulation of proxy voting; being a committed shareholder can be a complex, time-consuming and potentially expensive business. Proxy advisers could fulfil an important role, ensuring that distance, expertise and resources are not an obstacle to engagement. Nevertheless, safeguards are needed to mitigate risks that could originate from their privileged access to information and the influence they could potentially exercise.

- Embracing the United Nations Principles for Responsible Investment (PRI): the PRI are a set of voluntary guidelines for investors wishing to address environmental, social, and corporate governance (ESG) issues. The PRI aim is to help investors integrate the consideration of these issues into their investment decision-making and ownership practices, improving their long-term returns. Implementing these Principles could lead to a more complete understanding of a range of material issues, ultimately resulting in increased returns and lower risk (portfolio performance), particularly in the long term.

- Regulatory cooperation; companies operate in a global environment, thus, good corporate governance is a global challenge. Any action taken at EU level should be taken in full knowledge of what is in place and what is being prepared in the rest of the world, in particular, the USA.

22. How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?

Infrastructure investments are the typical example of long-term investment, and without doubt, asset management is a vital source of economic growth, as an intermediary in the savings - investment channel. If properly pursuing their mandate, asset managers should be stimulating overall economic development by continuously monitoring and allocating financial resources to the investments that offer the highest return in relation to their risk. As a first step in this direction, asset managers should develop infrastructure-specific skills, so as to be able to understand and assess the operational complexities. Even more important, asset managers should behave like owners, so as to engage with the company, but in order to monitor and engage effectively, the number of companies in the portfolio cannot be infinite.

Nonetheless, since clients can withdraw their money at almost daily notice, this might lead to excessive short-termism and a herd mentality on the part of asset managers, who need to keep a close eye on the liquidity of their investments and may therefore forego higher-return opportunities. Hence, a sound governance framework, more transparency, better communication with clients and better management of clients' expectations, may be needed to overcome this problem. It should not be overlooked though, that the clients themselves will also have to adopt more of a long-term view in order to evaluate the risk-return parameters of their portfolios appropriately.

In addition to this, strong support should be given to improve transparency of asset managers as regards both their fees and their investment and engagement policies. For instance, payment should not be related to the short-term performance of either the fund or the asset management firm; but rather, the asset managers' bonuses should be conditional on their performance over a longer defined period. This should be driven by the goal of making smart medium-term asset allocation decisions in the context of a long-term policy portfolio.

Moreover, some Member States have developed, or plan to develop, codes of conduct ('stewardship codes') for shareholders and asset managers. These codes constitute a positive development, since – *inter alia* – they deal with problems arising from the principal–agent relationship between investors and their asset managers. They can also have a positive effect on shareholder engagement and, ultimately, on the management of companies. On the other hand, engagement with investor companies requires investment of time and resources, which can be seen as a burden in a situation where mandates are being awarded based on fees.

23. Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?

One aspect of fiduciary duty which could be analysed and examined within the context of long-term financing may well be fiduciary management. Fiduciary management is an approach to asset management that currently is only used for the management of institutional assets (e.g. pension funds).

Fiduciary management could be used as a means for restoring trust between the asset manager and the investor. In addition, it could replace current contractual relationships in the investment chain. A practical consequence of this would be the obligation of the asset manager to make full cost and performance fee disclosure.

We agree that revisiting the fiduciary duties of asset managers could be useful. One option could be to make asset managers potentially liable if they failed to use their votes in the event that, subsequently, a company performed poorly (i.e. a failure to vote might be construed as negligent).

24. To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?

A greater integration of financial and non-financial information would encourage investors to understand the business and its potential future performance better and to contribute more effectively to investment decision-making. Not only investors, but also creditors, employees, and other interested parties could benefit from such integration.

Disclosure of specific risks and mitigation strategies would show investors that an entity is proactively responding to its external environment. Disclosure of an entity's activities, operating models and strategic direction would provide useful information on how an entity intends to generate business and value in the future.

However, non-financial information should only be included in the annual accounts, if material and relevant to understanding a company's financial and earnings' position and development. Any additional information should be presented in a sustainability report or similar document to avoid a company's annual or consolidated accounts being overloaded with an increasing number of disclosures with no direct relevance to its finances.

It is also important to balance the benefits of providing more information against the cost of producing it, as the imposition of more rules on reporting may, for example, discourage some companies from seeking funding on the capital markets. Compromise solutions, such as revision of the frequency and type of reporting, should be considered.

The Green Paper also notes that quarterly reporting may push market participants to focus on short-term results. The EBF believes it is unlikely that a change in the law or listing rules would change established behaviour or investor demands for information.

25. Is there a need to develop specific long-term benchmarks?

The definition of what is a long-term benchmark is not clear in the Green Paper. Credit ratings and benchmarks are highlighted as tools that traditionally focus on annual or shorter horizons. However, implicitly assuming the one-year period as the threshold for the long term is a questionable assumption.

Although the EBF understands the motives behind the aim of mitigating short-termism in investor behaviour, it is important to note that a wide range of economic and financial indicators, market benchmarks and credit ratings - with short-, medium- and long-term horizons - already currently exist. In addition, the majority of financial series exhibit considerable long-range dependency (or "long memory"), which means that long-term benchmarks will tend to present a noteworthy (although noisy) relation with short-term benchmarks.

26. What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

The different initiatives emerging from the EU at present in the SME Action Plan, as well as specific programmes such as that for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME), and the activities of the European Investment Bank and European Investment Fund, are to be welcomed. Wherever the EU is engaged in activity to assist SMEs, it should be as focused and cost-effective as possible, and aim to supplement the private market, without harming the dynamics of a healthy market mechanism.

Policy-makers are faced with finding a balance between the promotion of growth and jobs, and the temptation to over-regulate the commercial financial market. Some of the ideas put forward by policy-makers (for example concerning bank transparency requirements) could imply additional costs and risks for banks, which could in turn deter credit provision, rather than encourage it.

Ideally, policy should favour a voluntary or incentive approach, for example, by rewarding banks which can offer certain solutions with participation in EU programmes. Moreover, SMEs, and financing conditions and practices, vary considerably around the EU. Some flexibility and willingness to delegate to national level will be essential if policy measures are to meet the real needs of SMEs; and, on the banking side, avoid suppressing or duplicating systems which are already working effectively.

The range and scale of programmes established at EU level in support of SMEs bear witness to the strength of policy-makers' willingness to make a difference. But this diversity, and the need to put together funds from different budgetary sources, risks becoming a patchwork of services which is difficult for companies to access. There is a risk of creating overlapping instruments with no possibility for entrepreneurs to receive detailed and tailor-made information from one co-ordinated source. The EBF's members encourage the creation of a single window for access to the instruments; and, where possible, the use of already existing networks to ensure that the financial instruments are presented clearly to companies and implemented effectively. National Contact Points and the development of the role of the European Enterprise Network can, in collaboration with banks, help to achieve this.

Non-bank sources of finance.

The generic concept of SMEs covers a very broad range of business realities. There are two main types: (i) companies of a sufficient size and degree of development for access to the capital market, (ii) the remaining, fragmented universe in which bank intermediation is essential for the reduction of information asymmetries, and the efficient evaluation and monitoring of credit.

Heavy reliance on pure financial market financing may prove problematic for SMEs, as the size of their individual needs may be too small for large investors, while smaller investors may not necessarily be willing to commit funds to a small unknown entity in another Member State. In addition, many SMEs have substantial competitive disadvantages in terms of reporting, intrinsic risk, financial sophistication and external visibility. Consequently, mechanisms that reduce these disadvantages (such as specialised support entities or resizing by aggregation as "joint ventures for funding") would be useful in offering them greater capacity for diversification of sources of funding.

Other steps which could reduce SMEs' funding difficulties include: the use of rating services; legal certification of accounts; support services covering relations between companies and markets; and investment in the recapitalization of companies, and in the training and qualification of their human resources.

The measures already afoot at EU level to promote SME access to non-bank sources of finance such as venture capital, mezzanine finance and later-stage equity, are generally welcome as they should widen the range of options available to EU companies to align the EU market more closely with the diversity of that of the US. EU measures also recognise the need to encourage a revival in the use of securitisation as a vehicle for the pooling of bank loans to SMEs; a market which was successful and growing in the years before the crisis. Here banks can continue to take a lead role in sponsoring individual securitisations.

There is also potential for corporate bond markets to cater for unrated and smaller companies, as is the case in Germany.

However, SME access to alternative sources will be held back by the lack of economies of scale for small-scale issuances in the case of bonds, and, in some cases, admission and documentary requirements.

Attention could be given to ways to reduce the documentary burden, possibly through a standardised documentary platform, and to overcome the lack of verifiable public information, both of which may raise costs as well as making access prohibitive in many cases.

For many SMEs in Europe, bank loans are, will, and should remain the most important and most reliable source of financing, while alternative sources are not a better solution. The latter usually come with high financial costs and a bureaucratic/organisational burden.

Further consideration should be given to how investment in pre-revenue start-ups and entrepreneurs could be encouraged. Most of these may not receive equity from formal investors such as business angels or venture capital firms but may be able to generate equity from informal sources, such as family members, friends and business associates, as well as the owners' own funds. Entrepreneurs need a more supportive environment for securing equity investment and to understand the enterprise risk-taking also means financial risk-taking.

We would also welcome progress on the Entrepreneurship 2020 Action Plan aim for easier business transfers. The European Commission and its agencies should address the factors that deter or block transfers, such as regulatory or tax burdens, a lack of succession planning or transfer planning and transparent markets for business transfers. Financing instruments, including EIB products, should facilitate business transfers.

Lastly, the ECB, like other central banks, is able to play an important role in funding SMEs: i) by facilitating banks' access to the permanent lending facility and accepting loans to SMEs as collateral; and/or ii) by directly acquiring loans granted to SMEs and concentrating acquisitions in areas where the difficulties in obtaining funding are greatest. However, these measures might require political redefinition of the ECB's remit, with a re-balancing of its goals of price stability and growth of economic activity and employment.

27. How could securitisation instruments for SMEs be designed? What are the best ways to use securitisation in order to mobilise financial intermediaries' capital for additional lending/investments to SMEs?

The securitisation of trade receivables is already a critical source of capital for many SMEs.

Currently the financial industry is working to develop the Prime Collateralised Securities' (PCS) label in order to encourage development of the securitisation market in Europe on a harmonised and transparent basis. SME assets are considered highly suitable candidates for such a financing vehicle.

It would be necessary for the capital weights attached to this type of securitisation to reflect the associated risk correctly.

EU public support to stimulate the revitalisation of this market, which was developing with some promise before the crisis, is likely to be helpful.

One issue to be addressed is that the very rules that were considered necessary under CRD/CRR IV and its previous versions may have a detrimental impact on the appeal of such securitisation structures sponsored by banks.

> *28. Would there be merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitised products specifically designed for SMEs' financing needs?*

The distinct EU policy approach towards SMEs is considered appropriate and valuable. EBF members report that the guarantees available under the EU industry support programmes are particularly effective in leveraging private finance together with public support. An extension of the opportunities for guarantees will increase the supply and/or reduce the price of financing for SMEs. Overall it is important to guard against distortion through State intervention in areas which could be commercially viable.

Although past experience is not a guarantee of future performance, most, if not all, dedicated market segments of stock exchanges targeted at SMEs have failed typically, because of lack of information and lack of liquidity, which are criteria of paramount importance for investors. Investors will always have the alternative of investing in blue chip shares or government/corporate bonds.

For comments on securitisation, see questions 26 and 27.

> *29. Would an EU regulatory framework help or hinder the development of this alternative non-bank source of finance for SMEs? What reforms could help support their continued growth?*

No matter what actions are taken it is of great importance that alternative sources of finance are not anti-competitive towards the banks. It will also be important for interventions at national and EU level to complement rather than deter private sector sources of finance, such as banks, but also venture capital funds and private investors.

On the banking side, it could be helpful to address the cost of registration of collateral for financing.

> *30. In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of the European economy?*

The focus on improving long-term finance conditions for the European economy should concentrate on mitigating the lack of confidence and simultaneously changing the climate of risk aversion.

It is essential to adopt a unique package of measures to stimulate investment, the recapitalisation of companies, economic growth and employment, as is only fitting for a Union that is built on a foundation of cohesion, convergence and solidarity.

It is important to ensure less current public expenditure, better investment spending and higher revenues by revitalising economic activity (and not by raising taxation).

Stability of the political, economic, institutional and taxation framework is vital for channelling long-term funding in the European Union. Faster, more visible progress in budgetary and financial integration (in the latter case, particularly banking union) is important in restoring confidence and investment intentions.

One of the longer term challenges for the EU is its reaction to the phenomenon of an **ageing population**. A further analysis of pension systems could generate additional insight into their importance for generating pools of long-term financing in Europe.

The diversity of pension systems in Europe deserves a closer investigation, as savings in pension systems are generally directed to investments which support the growth of production and employment. They therefore become an important resource for maintaining stable economic growth.

The best approach for pension systems in advanced countries can be characterised as a four tier system[6]. A diversified pension system - as opposed to one which relies solely on the public sector pillar 1 - has implications for the capital markets, interest rates and the availability of long-term financing, all of which are believed to be of importance to the long-term growth prospects of Europe. In principle, a fully-funded individual pension system consistent with pillars 2, 3 and 4, focuses on long-term profitability and boosts longer term institutional investments. This limits fluctuations caused by short-term capital flows; increases the resistance of capital markets to crisis; and contributes to financial stability by making these markets safer for investors.

[6] Source: OECD; 2011 Working paper AWP 3.8; Retirement income systems for different economic, demographic and political environments, p. 9.

European Fund and Asset Management Association (EFAMA)

efama

European Fund and Asset Management Association

EFAMA welcomes the opportunity to provide a response to the Commission Green Paper on Long Term Financing of the European Economy.

We would first like to provide some general comments (please refer to I. General Remarks below) and then answer the specific questions raised by the Commission in its Green Paper (see under II. Responses to Specific questions raised in the Commission Green Paper).

I. General Remarks

1) Role of Asset Managers in long term financing

EFAMA and its members were extremely surprised to see throughout the Green Paper asset managers accused of pushing clients into short-termism and therefore hindering long term financing.

Asset managers are agents acting on behalf of clients, upon clients' instructions and in the interest of their clients. This relationship means that investment styles are in large measure the result of client preferences.

EFAMA understands that the Commission itself agrees that the decision to select investment strategies (long-term or short-term) is taken by the institutional investors and not by the asset managers. Institutional investors then instruct their asset managers to act accordingly. The determination of the investment strategy depends on the financial profile and needs of the investor and not of the asset manager. If institutional investors want to or are under the obligation to have access to a certain level of liquidity, a portion of investments will be made in short-term liquid assets. Again, EFAMA wishes to emphasize that this decision is taken by the client based on his needs and then communicated to the asset manager who is instructed by the client.

EFAMA agrees that there are a number of practices, especially the review of performance on a quarterly basis and the requirement for listed companies to issue quarterly interim management statements that tend to give too much attention to short-term consideration. Measures should be taken to remedy the situation and to foster long term financing in an efficient manner. For suggested measures please refer to our answer here below to Question 22.

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2) LTIFs

EFAMA welcomes the idea of the Commission to set up new pooled investment vehicles for long term financing in particular in form of the LTIF. By means of this new product EFAMA Members will be able to contribute to long term financing for Europe with their experience and expertise in managing collective investment schemes.

EFAMA considers that the key to the success of a proposal is to set out product regulation that adds real value and whose rules, such as diversification or redemption limits, are easily understood by investors and providers.

While EFAMA believes that LTIF should primarily focus on institutional investors, EFAMA also sees potential benefits in enabling retail investors to access this new fund type provided adequate safeguards and rules are put in place involving for the latter in particular a robust depositary system (comparable to UCITS) and more frequent redemption periods (compared to institutional investors) have to be implemented. As a pan-European brand, LTIFs should be able to encourage retail investors to channel more of their savings towards long-term investment throughout the EU, especially if they can obtain tax advantages in return.

3) Impacts of fiscal measures on long term financing

EFAMA shares the Commission's analysis that adequate fiscal measures will be a key factor to foster long-term financing in Europe.

EFAMA would therefore welcome tax advantages, for example for LTIF. However, these tax advantages should avoid any taxation arbitrage within the EU to the benefit of some Member States. If the path of tax incentives would be followed, it should be ensured in a level playing field manner across all Member States.

EFAMA has on the other hand strong difficulties to understand why the Commission, when seeking long-term financing for Europe, has at the same time launched a proposal for an Financial Transaction Tax which would be most detrimental for investments in Europe. As long as the proposal for a European FTT remains under discussion, there is a risk that – if adopted – it will exactly lead to what the Green Paper is trying to avoid. By not being applicable to all Member States, FTT would generate tax arbitrage to the benefit of the non-taxed marketplaces. By taxing the instruments which are the most common tools for long-term investments, such as equities and investment funds, it would create an incentive to push investors to very short-term investments such as banking deposits. By taxing the Money Market Funds, it would impede the optimal management of European issuers' liquidities.

EFAMA urges the Commission but also Member States to re-consider and reject this proposal. In this context, please refer to EFAMA's impact analysis regarding transaction tax[1].

II. Responses to Specific questions raised in the Commission Green Paper

1) Do you agree with the analysis out above regarding the supply and characteristics of long-term financing?

EFAMA agrees with the analysis set out by the Commission regarding the supply and characteristics of long-term financing:

Supply of long-term financing

EFAMA shares the view that there is a higher reliance on bank lending in corporate and household financing in Europe than outside of Europe. In the current crisis the high reliance on bank lending leads to difficulties in financing, worsening the cyclical shocks. A countercyclical effect would be desirable and could be achieved through a more diversified lending structure but also through modifications in current regulation of the finanical sector which currently limits the extent to which the financial markets can supply the real economy with long term financing.

EFAMA also agrees with the alternative potential sources of financing the Commission lists in its analysis: governments, corporates, households and external financing.

EFAMA agrees that there is a continued role for targeted public financing including anti-cyclical investments in public infrastructure. There are still public projects that can be justified especially in Member States with limited public debt. Furthermore there will always be long-term projects which should remain within the sphere of public authorities, due to the fact that they will not generate economic and financial interest on the part of other investors.

Financing by corporates other than banks could be at a higher level were there more incentives for the provision of institutional finance. Insurance companies generally benefit from stable net income flows (provided by premiums – not capital markets), and tend to have significant, well defined and long term liabilities. They are therefore incentivised to hold long term assets until maturity, and to act as shock absorbers. Other long-term investments come from asset managers acting on behalf of their clients. Asset managers continue to provide deep pools of long-term finance through active and index investment strategies. Active equity managers have many incentives to invest for the longer-term as turning over portfolios adds to costs and decreases the value of assets on which managers' fees are calculated. Fixed income managers will frequently look to hold positions to maturity to

[1] "Potential impact of the new version of the FTT on the UCITS Industry", on EFAMA website www.efama.org: http://www.efama.org/Publications/Public/130313_FTT_Impact_Analysis_2013.pdf

benefit from consistent income streams. Positions in index portfolios are held for as long as a company meets the requirements for inclusion in the index.

Financing coming from households, as rightly underlined by the Commission, is the main ultimate source of funds to finance investment, whether via savings products or governments. In the medium and long term, one way to increase the level of long term investment could be to increase the level of household savings. This being said, following the crisis, household budgets are stressed and many are focussed on day to day needs and paying down debt. Furthermore, the household with less stressed budgets tend to prefer highly liquid savings vehicles. Both during a crisis but also under normal circumstances households tend to show an extremely passive attitude with regard to savings allocation. This aspect is important since it enhances the importance of the liquidity of financial instruments, including those intended for medium and long-term financing. The hesitation around savings allocation and an appropriate risk pricing policy are likely to enable mobilisation of household savings, whether directly or indirectly. On the other hand, the greater complexity usually associated with long-term investments requires the mobilisation of institutional investors to help channel private savings towards long term investments.

Characteristics of long-term financing

EFAMA welcomes the wide scope of long-term financing proposed by the Commission. Many areas in education, housing and healthcare would benefit from long term financing and contribute significantly to raising Europe's productive capacity and competitiveness.

2) Do you have a view on the most appropriate definition of long-term financing?

EFAMA believes that it will be very difficult to find an appropriate definition of long-term financing. Criteria to be taken into account in this definition could encompass the form of financing, the source of financing, the maturity of the investments as well as the lifespan of the underlying assets.

A number of EFAMA Members recommend basing the definition of long-term financing on that of the G20[2], "finance of at least five years maturity as well as FDI", including sources of financing that have no specific maturity (e.g. equities). Some EFAMA Members propose to exclude FDI from this definition.

[2] *Long-Term Financing Investment for Growth and Development, February 2013, World Bank.*

3) Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

EFAMA agrees with the Commission analysis that in order to meet forthcoming capital requirements restructuring of bank balance sheets is expected to continue which will reduce long-term funding opportunities.

Despite these restructurings requested by capital requirements, EFAMA expects that banks will maintain a key role in providing finance for infrastructure and SMEs through origination and securitisation. Banks have acquired in the last decades the ability to originate deals and conduct credit analysis. However, as a result of the capital requirements, banks will tend to reduce assets on the balance sheet, i.e. banks will serve as originators of long-term financing given their expertise in assessing credit risk and corporate knowledge, after which they will increasingly sell these assets into the market, following a model similar to that used in the USA. Banks currently have the origination capabilities and networks to be the main contact for an issuer -whether a SME, mid-market corporate or a specific borrower -who is seeking long-term financing, such as for an infrastructure project. To date, banks have viewed these contacts from the perspective of providing credit, i.e. potentially using their proprietary capital to lend to these issuers, or (less frequently) as a broking intermediary between the issuer and the capital markets. Banks will evolve more and more from credit provider to originators. Going forward, banks could also act as intermediaries simply introducing these issuers to non-bank providers of capital, thereby earning an introduction fee and not exclusively using their own capital.

EFAMA considers that these activities (origination, securitisation or intermediation) should be encouraged.

4) How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?

EFAMA agrees that national and multinational development banks are currently playing a significant role by supporting a vast variety of projects in a very efficient manner. Development banks are contributing when they are guaranteeing risks that the private sector is unable or unwilling to take. By virtue of their long-standing presence in the debt markets, development banks have achieved certain credibility in the minds of investors. If such banks were to provide partial guarantees or act as sponsors of issuance programs to finance long-term investment, smaller investors who may not be sufficiently staffed to assess these new instruments could obtain comfort in the structure and contribute funds for investment.

In order to be most efficient in the support of the financing of long-term investment, development banks should focus on areas where no private financing is available or remains scarce. In particular, development banks should avoid undercutting private firms by providing finance at a lower cost

where financing is already available. This may result in a completed deal in the short term but will slow the development of the market in the medium term. For example, the financing of development banks is very necessary for infrastructure projects which have crucial needs of money. Development banks should on the other hand be more reluctant to extend their activities to the general financing of companies, which may be better financed through financial markets, including through asset management companies.

Furthermore it is important for the development of a long term institutional market that investors have access to quality investment opportunities and are able to assess, analyse and price the underlying investment in a transparent manner which becomes difficult if development banks intervene too readily. By supporting existing funding vehicles and through their own initiatives (such as project bonds) development banks are helping to build awareness of, and confidence in, a relatively new market and asset class.

5) Are there other public policy tools and frameworks that can support the financing of long-term investment?

Stable and predictable environment

Independently of the public policy tool or mechanism chosen, investors need a stable environment and predictability of events. The longer time horizons investments are sought for, the longer the environment should be stable and predictable. EFAMA would like to underline two aspects in this regard:

First, a stable political and regulatory environment is a pre-condition of financing of long-term investments. Political and regulatory changes impact on the financing of long-term investments. Frequent changes are perceived as an instable environment and hamper investments. Furthermore, decisions with retroactive effects on existing investments and project portfolios of investors have a particularly negative impact for any future investments. Political and regulatory risk is therefore key impediment to private infrastructure investment. This risk either inflates the cost of financing or makes investing in this sector almost impossible for certain participants. For example due to their need for stability and predictability of returns, insurers are more likely not to invest than to take this risk. Because infrastructure investments seldom offer an upside, and the best that investors can hope for is stable cash flows, any risk to returns can make the investment unattractive compared to alternatives.

Secondly, EFAMA would support initiatives to incentivise visibility of upcoming infrastructure projects. Early announcements and high transparency regarding projects will enable investors to plan and prioritise their potential deals. At a national and European level the visibility of the infrastructure pipeline seeking private finance could be made clearer, particularly for small and medium sized projects. The risk of a stop-start approach is that asset managers do not maintain teams capable of doing these deals. Firms need to maintain teams capable of undertaking high quality due diligence,

which can take months or years for a project. The flow of projects should be stable and visible to ensure institutional investors are geared up to provide the finance.

Adverse effects of recent and on-going regulatory changes on financing of long-term investments

The capital treatment of investments by institutional investors is one of the decisive factors in attracting long-term investment from institutional investors. Institutional investors will commit funding to long-term projects if the capital treatment is favourable and the project's risk profile is structured correctly.

From this perspective, existing and proposed revisions to the capital treatment of assets, such as Solvency II for insurance companies, are unfortunately having a hampering effect regarding long-term investments (please also refer to questions 6 and 7 below). Basing capital calibrations on models which rely on pricing of listed securities and credit ratings will not favour long-term investment. Using these models causes long-term investments to be considered as more volatile, as marked-to-market pricing is affected by technical factors linked to declining liquidity of public markets (due to Basel 3's impact on banks) rather than the true credit risk of receiving coupons or interest and principal from a borrower. Put another way, long-term investments are not compatible with the short-term approach which is inherent in using Value-at-Risk to determine capital charges. Additionally, basing the standard model for Solvency II on credit ratings does not tie in with the EU's work on credit rating agencies and reducing the reliance on ratings. It should also be stressed that the introduction of a tax on financial transactions would undoubtedly penalize investments in investment funds, by taxing both their portfolio transactions and redemptions (if the option proposed in the draft directive under consultation comes to be accepted). Compromising the profitability of these financial instruments will, of course, negatively impact the interest in and the preference for them and the investments they may make in long term financing of the economy. Finally the discussion about shadow banking[3] connected to funds is likely to hamper the readiness of investors to invest into vehicles such as LTIF if the Commission will not narrow the scope of the shadow banking debate by focussing its attention on unregulated activities potentially threatening financial stability, a concern which does not apply to regulated vehicles as UCITS at present and LTIF in the future.

Long term financing through public procurement

With regards to public procurement, long lead time and low "hit rates" are a disincentive for investors who have to dedicate sufficient time to analyse, price and approve a transaction. Each transaction can take months to work through and requires important resources from investors. EFAMA Members report about projects which are visible but have frequently long delays in closing deals, often because of poor procurement or project management skills. They consider this a major

[3] C.f. http://ec.europa.eu/internal_market/consultations/2012/shadow/registered-organisations/efama_en.pdf

impediment to smooth and efficient transactions, thereby dis-incentivising investors. Capital market development would be facilitated by a change in public procurement rules which would shorten the time period between pricing and closing. Also, local and national governments should invest in developing in-house procurement and project management skills.

Furthermore, in the framework of public procurement projects, compensation to investors for early repayment should be included as feature of the investments. Long term fixed rate investors offer significant benefits in terms of fully committed long term finance, competitive funding, and transparent pricing. The corollary is that fixed rate investors will require compensation if they are repaid early – voluntary prepayment – and this should be accepted as a normal cost of long term fixed rate funding.

In the framework of public procurement, public procurement agencies should also more frequently take into consideration that banks sometimes offer cheaper funding than other institutional investors in the expectation or hope that they will be able to profit from selling ancillary services. Clearly, it is difficult for public authorities to select a provider offering a higher cost of funding even though this is 'cleaner'. Public procurement authorities should be more aware that insurers and asset managers, because they are more likely to hold assets until maturity, will offer a level of engagement, commitment and stewardship which cannot easily be quantified.

Long term investment requires long term saving

EFAMA agrees with the Commission analysis that households represent one crucial source of funding of long-term investments given that LTIF would give them the opportunity to diversity their portfolio beyond highly liquid instruments like equity or debt instruments. A critical part of channelling more funding into long term investment is to increase the level of capital available in the first place, which means taking meaningful steps to increase long term savings by households. In this context an effective and efficient way to achieve greater long term saving rates is for Member States to adopt auto-enrolment or mandatory pension schemes. Of course, this would not only increase potential funding for long term investment, this would also help households cope with negative economic shocks (such as unemployment), meet medium-term objectives (such as paying for university), and increase their retirement income. Governments should also promote the development of long-term savings through increased awareness amongst the population, financial inclusion policies, and the promotion of financial literacy and investor education.

National public policy tools and frameworks

Some EFAMA members have mentioned in their responses specific public policy tools and frameworks at national level which can support the financing of long-term investment. In this context please refer to the individual responses by EFAMA members.

6) To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

Extent to which institutional investors can play a greater role

Given the evolving nature of reducing the size of the European banking system, institutional investors are likely to assume an important role in long-term financing. EFAMA considers that a large number of institutional investors have a significant interest for long term investments with regular yield, especially pension funds and insurance companies. These investors would be very interested in playing a greater role in the changing landscape of long-term financing.

The extent to which institutional investors can play a role varies because their degree of sophistication varies. Few large investors have dedicated teams that can originate, structure as well as implement and manage private long term investments in both debt and equity. Many large investors will continue to invest through investment funds if at all. The increased proliferation of sophisticated fund managers managing long term funds is therefore an important step towards the wider participation of institutional investors. Many such managers are now developing their activities in private long term investment in both debt and equity.

Reasons for playing a greater role

EFAMA and its members see a growing interest of institutional investors in long term investments for a number of reasons.

The predominant reason for institutional investors is the search for yield in the current markets. There is currently a growing focus on secure income assets (infrastructure debt, commercial real estate debt) and other sources of capital growth (infrastructure equity and private equity). From a market value volatility perspective, these assets do not appear to require additional economic capital. In addition, there are several key benefits appreciated in particular by insurance companies.

Further there is currently evidence of higher spread than liquid credit through premiums due to the added complexity of sourcing and managing these OTC assets. For debt alternatives, though there is little pricing data to calibrate market value VaR models to, there is reasonable evidence of strong cash flow characteristics, and an intrinsic diversification of credit (default) risk. Furthermore private equity and infrastructure equity assets offer a diversified source of risk, and high returns – though their ability to match liabilities precisely is more limited. Insurers are in general more cautious about increasing allocation to these asset classes. Overall, for debt alternatives, an effective matching adjustment framework, coupled with hold to maturity investment should make these assets more attractive, as mark to market volatility is de-emphasized in favour of a cash flow orientated investment focus.

Another group of investors wishing to pursue a more active role are venture capital funds and business angels. Such investors are a very strong motivating factor in the economy because they

finance projects of an innovative nature, thereby supporting the creation of companies and/or their expansion into international markets, which in turn has an impact on job creation, increasing exports and R&D. Furthermore, such investors do not need to have liquid assets on the balance sheet because of the closed nature of the funds, although they do need market-driven solutions to exit from the investment. The stock market listing of these funds would generate liquidity for participants without jeopardizing the stability of the investment and would permit investment funds to invest, thus fulfilling the regulatory requirements for adequate liquidity. Funds generated in this way could increase long-term financing to the economy through the promotion of financial markets, including the stock market.

Factors impeding a greater role

EFAMA and its members currently also see a number of factors discouraging investors from providing financing to long-term investments.

Asset allocation by institutional investors tends to provide an upper limit on the size of illiquid investment within their portfolios. Pension plans will soon be confronted with net payments to participants as the ageing of the workforce in Europe grows. Going forward for many pension funds this will increase the need for greater liquidity. The same applies to the life insurance sector. Any J-curve effects will become less acceptable for institutional investors when net payments become a fact and are on the rise (which they already are in quite some member states and pension schemes). While there will still be a need for financing public investments, it may ultimately get financed through higher product prices of preferred outlays on new and replacement utilities.

Institutional investors are often also hampered by the complex nature of infrastructure investments. Often infrastructure financing contains a very high legal content that leads to complexity that not all institutional investors are able to cope with. Larger investors with dedicated infrastructure finance teams will not have an issue with such complexity, but smaller investors will. For governments to tap into the pool of funds that smaller investors might be able to supply, standardisation of complexity needs to be accomplished.

Another key issue is improving the quality of data available. Some EFAMA Members mentioned that for newer asset class – including those discussed under Long Term Financing, insurers are demonstrating a clear need of high quality data and analytics from the outset. This includes not only the expected asset level data, but also requests for credit analysis and time series data and greater take up of infrastructure will develop when this data becomes more widely available.

Ways in which institutional investors may play a greater role

Institutional investors would play a key role in the launch, support and development of projects in the area of investments designated as ESG/RI (Environmental, Social and Corporate

Governance/Responsible Investments), which certainly will be an area to stimulate in the context of European economic development.

The implementation of a taxation regime which encourages long-term savings, and which is stable, is essential for the sustainability and development of these collective investment financial instruments and of Pension Funds which, in turn, will be able to contribute to the financing of long-term projects.

EFAMA considers that asset managers will be instrumental to allow institutional investors to play a greater in the changing landscape of long-term financing. Asset management companies are strictly regulated and have the capacity to employ specialist teams. They are therefore highly skilled to help institutional investors take up their greater role. Furthermore, by investing through investment funds managed by asset managers, institutional investors can reduce risks, both in their choices of investments and in their diversification of investments because investment funds themselves diversify the assets they invest in.

7) How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?

EFAMA shares the Commission's analysis that insurers, reinsurers and pension funds are among the most important institutional investors.

Insurers

For insurers the proposed revisions to the capital treatment of assets under Solvency II are unfortunately having a hampering effect regarding investments. These issues must be resolved in order to avoid negative consequences on the ability of the insurance companies to undertake long-term investment in the economy.

In this context, EFAMA considers the treatment of long-term guaranteed products including pension products a key issue. The concept of a 'Matching Adjustment', and a correct calibration, must be included in Solvency II to ensure that insurers do not hold unnecessary capital to pay for these products. The current rules for Matching Adjustment require that all assets must be of investment grade. Investment in BBB assets is also specifically dis-incentivised by the rules, which introduce additional limits of 33% on amount of BBB assets in the portfolio and the restriction on the level of Matching Adjustment on BBB assets (to be no higher than the higher of AA or A rated). Because infrastructure assets are typically rated BBB or below, these restrictions introduce an obstacle for insurers to invest in long-term assets.

For insurance companies, EIOPA's recent discussion papers on Solvency II have been analysed by EFAMA members. These EFAMA members had a number of comments on topics such as level of

capital charges, prepayment risk, structured credit and SCR calibrations and matching adjustment (for details please refer to the answers submitted directly by these EFAMA members).

IORPs

Regarding IORPs, EFAMA supports the Commission's recent announcement not to proceed with the application of Solvency II-style prudential rules to IORPs. Application of the Solvency II rules to IORPs would have a very negative effect and would result in the accelerated extinction of defined benefit funds, and would also have serious implications in terms of growth potential of defined contribution funds, to which the same regulations will apply.

8) What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?

Pooled investment vehicles

EFAMA expects an interest by investors in pooled investment vehicles which could serve to facilitate investment by smaller and medium-sized institutional investors into infrastructure in Europe. Small and medium-sized institutional investors are currently often not able or willing to invest directly into infrastructure throughout Europe. Because of limited amounts of in-house expertise on evaluating and executing long-term investments institutional investors have an interest to pool resources. By doing so they can generate the scale needed to either build an infrastructure investment team or hire an external manager at a competitive cost.

Creation of new types of pooled investment vehicles

Most EFAMA Members consider that there would be room for the creation of new pooled investment vehicles to provide finance for infrastructure and SMEs. EFAMA therefore would welcome the creation of a new European brand of pooled investment vehicles investing in long term financing projects. These pooled investment vehicles should be able to attract investors throughout Europe based on a European passport granted if they meet certain requirements on valuation, diversification and asset types. The passport could also be granted to existing structures fulfilling the requirements.

In particular the development of long-term investment Funds (LITF) with a uniform regulatory and ideally tax incentives framework could offer a new channel of financing the economy by widening the scope of eligible assets towards non-listed companies (stocks and bonds), debt securities business (corporate loans), infrastructure financing, etc. The Commission is right to consider that a new LTIF could facilitate the raising of capital across the Union. Done carefully, rules on LTIFs could inspire the same confidence as UCITS, in particular if they offer sufficient safeguards with respect to asset valuation, diversification and transparency. The key to the success of a proposal is to set out a

regulatory framework that is easily understandable by investors. In this context, it will be particularly important to highlight that investing in longer-term assets require an adaptation of redemption limits and valuation rules in facilitate the liquidity management of the funds and avoid excessive volatility.

EFAMA considers that LTIF should focus on institutional investors and wealthier/more sophisticated retail investors, as even small or medium sized institutional investors (local government pension trustees, for example) can lack expertise in long term investment.

EFAMA also sees benefits, provided adequate safeguards and rules are put in place, in enabling retail investors to access this new fund type, especially considering that in several Member States investors that might legally qualify as a professional investor within the meaning of Annex II of Directive 2004/39/EC are nevertheless considered to be retail investors (such as local governments, corporate, foundations and even clerical organizations). In particular, retail investors require a robust depositary system. Also, retail are usually not interested in investments that provide no exit possibilities for several years unless they obtain significant advantages in return, such as associated tax benefits and/or the inclusion in some form of pension savings schemes, for instance. In this context, LTIF would appear as a new type of investment fund into which retail investors' retirement savings could be channelled to increase the diversification of assets towards less-liquid investments.

EFAMA considers that LTIF should focus on institutional investors, as even small or medium sized institutional investors (local government pension trustees, for example) can lack expertise in long term investment. This being said, EFAMA also sees potential benefits in enabling retail investors to access this new fund type provided adequate safeguards and rules are put in place. In particular, retail investors require a robust depositary system. Also, retail investors seek a high liquidity and shorter investment horizons and would therefore need more frequent redemption periods and tax advantages. In this context, LTIF would appear as a new type of investment fund into which retail investors' retirement savings could be channelled to increase the diversification of assets towards less-liquid investments.

Changes to existing regulation to foster investment in pooled investment vehicles

Independently of the use of existing pooled investment vehicles or the creation of new types of pooled investment vehicles EFAMA believes that changes to existing regulation could also foster investment in these pooled investment vehicles. For example investment would benefit from an inclusion of such vehicles in standard risk and capital weightings such as under Solvency II. National restrictions on institutional investors investing in non UCITS vehicles would also have to be amended by Member States.

Platforms

EFAMA does not see significant barriers preventing institutional investors from pooling their resources through investment platforms. Investment platforms will however require expertise, either

internally or externally, to conduct the investments. Therefore, they are not particularly different from a fund model or from pooled investment vehicles.

9) What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?

EFAMA understands that existing instruments which could enhance the capacity of institutional investors to channel long-term finance include SME ABS, corporate loans, private placements, project bonds (including EU/EIB project bonds) and infrastructure loans. If these instruments were to be further developed, a better accounting and regulatory treatment of unlisted investments would be required. It is important to recognise that the minimum size of listed issuance to get into benchmarks is getting higher and banks are reducing their securities stock due to deleveraging. As a result, borrowers will be much more likely to issue unlisted securities.

Some EFAMA Members mentioned a reasonable recent activity in the "listed companies" space in infrastructure that indicates a significant appetite for listed vehicles owning infrastructure assets. These vehicles all own actual infrastructure assets, are listed and have both institutional and retail investors.

10) Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?

EFAMA has been advocating for the last years that the Commission should, in addition to the existing impact assessments conducted for each prudential reform separately, conduct an overall impact assessment taking into account the cumulative effect of the current and planned reforms. EFAMA therefore welcomes the analysis in the Green Paper rightly recognizing the substantial cumulative impact of all the planned reforms on banks, insurance companies and other financial players.

As mentioned before, the current and planned prudential reforms for banks and insurers will hamper financing of long term investments, because it discriminates these investments compared to other investments, such as investments in government bonds. Furthermore, planned reforms such as the introduction of the FTT would have an additional negative impact on long term investments.

11) How could capital market financing of long-term investment be improved in Europe?

EFAMA shares the Commission's analysis that alongside institutional investors, well-functioning and deep capital markets and infrastructures are needed to offer a wider range of instruments to channel long-term finance. Currently, various obstacles hamper the most effective functioning of the capital markets in Europe:

Capital markets obstacles

In order to improve capital market financing of long-term investments, existing or foreseeable weaknesses of the capital markets should be addressed. A number of these weaknesses derive from the recent regulatory changes which originally aimed to make financial markets more efficient and effective, to reduce systemic risk, to improve market infrastructure, to enhance transparency and sound consumer protection.

EMIR substantially reduces counterparty credit risk, however, (i) funds and asset managers (together with the entire buy-side part of the financial industry) see their counterparty risk increase by the effect of centralisation of exposure on fewer clearing members and possible waterfall effect that could impact the value or amount of the asset held on behalf of their clients; (ii) central clearing and collateral requirements for uncleared trades will significantly reduce the liquidity available and eligible to deliver as collateral, especially when borrowing is not allowed for some structures; (iii) it will step up the cost of hedging via OTC derivatives, impacting the return on investments (as e.g. cash deposit as collateral will not be remunerated as they used to be); (iv) the increased in costs (collateral availability, assets transferred without remuneration of cash) will reduce the use of derivatives instruments that are also used as "insurances for trading" (covering for example a risk of default - direct risk or correlated risk - or a risk in currencies exchanges to finance cross-boarders economic financing) and (v) the proposed restrictive conditions on repos is setting barriers to developing safer and efficient collateral transformation required to meet G20 and EMIR mandatory collateralization of derivatives or credit while not addressing the need for national bankruptcies legislations.

MiFIR, currently still under negotiation, introduces pre- and post-trade transparency requirements. These should be calibrated very carefully in order not to hamper market makers in their capacity to provide liquidity, especially for non-equity products and more importantly to support the benefits for end-investors of "larger grouped transactions" (demand for waivers). MiFIR is setting up too many restrictions with regard to the OTF implementation conserving vertical business models which hampers SME to seek better equity capitalization through adequate trading venues.

IMD II is compared to MiFID II far less committed to the goal of an enhanced consumer protection leading to an unlevel playing field and a capital accumulation with insurance companies that are by regulatory means short term biased.

Short Selling Regulation allows market participants to buy EEA sovereign CDS only if they have exposures that are "meaningfully" correlated with the relevant sovereign debt. This makes the use of sovereign CDS as a proxy for hedging exposure in a country much more difficult. As such, it reduces international investor appetite in the bond market of smaller European countries and adversely impact debt issuance levels.

In order to stimulate long term initiatives, it is crucial that regulatory measures do not make hedging uneconomical and burdensome. It would deter investors from providing funding or else, leave them un-hedged which would increase risk in the financial sector again. Indirectly, the barriers set on

transacting in financial instruments will push away asset managers from investing in less streamlined instruments or less mature markets with the direct consequence of less or no long term investments in SME.

Structural obstacles

Structural reforms, such as the upcoming response by the European Commission to the Liikanen report, may bring more negative effects on capital markets, in particular the envisaged moving trading activities into separately funded and capitalized entities. EFAMA doubts that this exercise would meaningfully reduce systemic risk any further, given all the regulatory steps already taken in that direction. Moreover, it would significantly step up the cost of funding of the separated entity, making trading and hedging activities much more expensive at the entities concerned, thereby reducing market liquidity, competitiveness and return on investment. It will be crucial to have a clear view of the cumulative impact on the real economy of regulations put in place already, before moving to further structural reforms, knowing that banks will need to be able to fully support and develop the potential of capital markets as a source of long term financing.

In order to improve long-term investment in Europe, investors from outside Europe will need to be attracted. Therefore, international harmonisation and cross-border dialogues between regulators will be key in developing a global level playing field, whereby free flow of capital is promoted.

Tax obstacles

Further to the weaknesses in capital markets outlined above, as noted above the proposal to introduce a FTT in a number of European countries, would have a negative impact on the investor's decision as to where to invest. As the scope of the proposal is extremely wide, it would have a significant impact on the cost of financing through capital markets as again, it would make transacting and hedging much more expensive within the FTT zone. Consequently, it would lower the return on investment which would drive international investors away from investing the countries involved all together. This initiative seems counterproductive to the intention of stimulating long-term financing, where tax reform could actually be a very meaningful tool to incentivize investors to engage in the long term in Europe.

Accounting obstacles

Capital market financing of long-term investment could be improved by avoiding different accounting and regulatory treatments of instruments with the same economic purpose between banks and non-bank investors. Banks can hold-to-maturity, as can long-term investors. Unfortunately, regulators seem to want to make non-bank investors mark-to-market these cash flows while allowing banks with the same cash flows to treat the investment at par. This prudential treatment exists despite the

fact that the long-term investor (such as an insurance company) has long term liabilities while a bank has short term liabilities (such as deposits) that can be withdrawn at very short notice.

12) How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?

EFAMA considers that managers' fiduciary duties require managers to take economically, socially and environmentally sustainable growth into account in the investment process. Managers shall assess how these criteria can contribute to adding long term value to clients' investments. This needs to be a dynamic and evolving process rather than a pure box-ticking exercise.
One EFAMA Member suggested the introduction of incentives for companies to distribute dividends in the form of shares rather than in cash could be an interesting means to consolidate shareholders' equity and to provide financing without increasing corporate indebtedness. Finally, this suggested mechanism could encourage companies to reinvest more in long term projects through self-financing solutions reducing in the same time the observed equity gap.

13) What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?

No comment.

14) How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?

EFAMA considers that securitisation markets can be an efficient tool to allow investors to provide capital to different issuers, including governments.

The first hurdles currently mentioned by investors to the securitisation markets in the Europe are the different proposed regulatory reforms for the main investors. Regulatory reforms proposed under Solvency II for insurers will have a hampering effect on securitisation markets. Reforms planned for money market funds by the European Commission will no longer allow these investors to purchase asset-backed commercial paper.

EFAMA understands that although issuance is lower than it has been historically, this is not necessarily a sign that the securitisation market is not functioning/needs reviving. For example, low volumes of publicly placed prime RMBS is not an issue of investors unwilling to invest, but

alternative sources of funds for issuers (such as central bank schemes) and a reduced willingness to lend and thus requirement for less funding.

The second hurdle is seen in regulatory intervention in order to standardise securitisation structures. It seems difficult to envisage standardised structures across Europe when the underlying financial systems, products, legal frameworks are so varied. Funds and asset managers need sound and reliable securities to invest for the longest possible term for direct investment and to deliver as collateral. The quality and the reliability of those structured instruments can only be reached through development of pre-defined and unchanging criteria in each issue, especially if those issues receive welcomed quality labels.

15) What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?

The promotion of long-term savings and the strengthening of the European market for pensions have been at the heart of EFAMA's priorities for many years. EFAMA first launched its initiative for the creation of a retirement savings product at EU level back in 2010. We have named this product as "*Officially Certified European Retirement Plan*" (OCERP).

Taking into account that retirement savings is an important source of patient capital, EFAMA believes in the merits of bridging retirement savings and long-term investments. As such, the creation of the OCERP as a European labelled personal pension product built on robust consumer protection rules would not only foster investors' confidence in financial products for retirement savings but would also help financing long-term, less liquid assets. As such, EFAMA strongly supports the design of an EU model of a European personal pension product that would contribute to channel retirement savings towards long-term investments.

The introduction of an OCERP would have a wide range of important benefits. First, it would enhance the volume of savings available for long-term investments throughout Europe, thereby contributing to higher growth and job creation. Second, it would stimulate greater competition in the European pension industry and so contribute to greater efficiency and lower costs. Third, it would represent an important step towards the portability of pension products within the European Union, thereby facilitating people and job mobility.

EFAMA believes that the asset management industry has a key role to play in the provision of new retirement solutions that could benefit the retail investors whilst answering the needs for long-term investment in Europe.

As the asset management industry's leading European representative body, EFAMA wishes to reach out to policy-makers to discuss the OCERP proposal further and to continue the open dialogue with the European authorities including EIOPA, on the development of such product to contribute to the long-term financing of the European economy while keeping the retail investor's protection and interests at the heart of this effort.

16) What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?

EFAMA understands that CIT reforms are a competence of the Member States. Reforms and in particular tax harmonisation decisions which need to be taken by unanimity will be difficult to achieve. Legislative proposals will be slower than agreeing an understanding of best practice reforms to tax regimes.

17) What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?

EFAMA advocates tax incentives for long term savings, including UCITS, AIF and LTIF. Without tax incentives, LTIF will not be attractive for retail investors.

Furthermore, EFAMA would like to underline once again the highly detrimental effect to be expected from the introduction of the FTT which will bring taxation arbitrage between Member States (depending of their adoption or not of the FTT) and a direct prejudice for long-term saving tools such as equities – while banking saving accounts would not be taxed.

18) Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities?

Different EFAMA Members have mentioned national tax incentives in their Member States. Please refer to their answers directly.

Furthermore, EFAMA would like to point out that historic tax policy in most OECD countries has been to accept that foreign investors in transferable securities can invest without paying any tax other than withholding on income (i.e. capital gains are tax free) but to tax fully investment in any real property. Thus, tax policy dis-incentivizes foreign investment in infrastructure assets.

Also, the requirement for long periods of investment, as occurs with products aimed at reform, and the obligation that they be constituted as autonomous funds, strictly supervised and established exclusively for the creation and payment of retirement benefits are principles that avoid the risks referred to in this question.

19) Would deeper tax coordination in the EU support the financing of long-term investment?

Some EFAMA Members considered that deeper tax coordination would support the financing of long term investment. They considered that already simply by produce a similar approach would be beneficial.

Other EFAMA Members did not consider that deeper tax coordination would be useful.

20) To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

EFAMA agrees that the use of fair value accounting has led to some short-term investor behaviour. There is a delicate balancing act between presenting financial information in a way that reflects asset and liability values at a point in time and performance for the period then ended, and providing information that enables investors to understand the longer-term attributes of those assets and liabilities. Fair valuation of financial instruments does reflect the value on a reporting date; subsequent market recoveries can be tracked by investors and factored into their decision making.

EFAMA considers that it is important to make a distinction between the presentation of assets and liabilities in the balance sheet, and how movements in these assets and liabilities are reported in statements of financial performance. For some institutional investors such as insurance companies fair value for assets and current value for liabilities is the most appropriate basis for reporting in the balance sheet in general purpose financial statements, as it provides users with the most relevant picture of an insurance company's financial position, using all information available at the reporting date.

However, it is important that accounting standards adopt appropriate principles for reporting the performance of insurance companies that enable users of the financial statements to distinguish between short term volatility and long term performance.

Alternatives to fair value

Fair value accounting is usually more conceptually robust than alternative accounting treatments, such as the historic cost method, "buy and hold" and "target date approach". However, fair value accounting may have certain drawbacks.

In particular, the valuation of long-term assets using the fair value principle is normally associated with two types of problems: on the one hand, complex and illiquid markets have difficulty determining the actual fair value of the assets and, on the other, market volatility has a multiplier effect on the value of financial instruments. For these reasons EFAMA considers that in duly justified circumstances (e.g. when market values are not meaningful because the market is highly illiquid) an appropriate mark-to-model can be legitimate.

The main alternative method to fair value accounting is historic cost accounting, which involves recording assets on balance sheet at their acquisition price. Historic cost accounting is generally a more conservative basis of accounting as gains, particularly in periods of rising prices, are deferred until settlement. There is little debate about the reliability of historic cost accounting values,

however their relevance is questionable. Indeed, the historic cost values are only relevant if there has been no material change since the date of acquisition/recognition. Clearly, in the overwhelming majority of instances asset values will have fluctuated significantly since acquisition/recognition. Therefore, the financial statements that these form part of will not accurately reflect the underlying value of the assets at the reporting date. The impairment rules under the historic cost model would result in a diminution of value being reflected, but there would be no recognition of positive movements above the asset's cost. This would make it difficult for market participants such as investors to accurately appraise the entity that owns the asset. For example it would be more difficult to distinguish between entities that are performing well relative to their competitors and similarly identify poorly performing entities. Accordingly, the important control of market discipline would be less effective due to the lack of transparency in the financial statements.

The buy and hold and target date approach methodologies are designed to reflect management's intent to hold the assets for a longer time horizon. The buy and hold method would utilize the asset's forecast return as a basis of valuation. This is a significant departure from fair value based on the current exit price, being the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Clearly, this would add a higher degree of subjectivity to the asset's valuation and may result in management being able to manipulate the forecasts in order to support an asset's carrying value. The target date approach proposes a time-weighted, mixed valuation model of cost and market value. This would be used to value assets that are subject to a binding commitment to hold for a long time horizon, with the objective of reducing short-term valuation volatility. However, it is likely that market participants will seek to convert these hybrid values back to pure market values and therefore it is doubtful this methodology would have the desired impact.

Although fair value accounting is not a perfect solution EFAMA considers that it is often preferable to the available alternatives. Therefore EFAMA would not be in favour of abandoning the fair value model where currently applied. Nor would EFAMA be in favour of reducing the frequency of required reporting. However, in some circumstances and in particular for non-liquid assets, mark-to-model can be legitimate under certain circumstances and conditions.

Last, it should be ensured that IFRS is modified to enhance it in ways which help to mitigate short term investor behaviour.

Modifications to enhance IFRS

Nonetheless, IFRS can be further enhanced in ways which would help to mitigate short-term investor behaviour. EFAMA supports the aims of the IASB in its projects in respect of accounting for insurance contracts (IFRS 9 Phase II) and financial instruments (IFRS 9) although the final outcomes and interactions between these projects remain to be seen. The criticism of IFRS and changes envisaged by IASB in this context include the following:

- *Additional disclosure*

There are a number of new disclosures under IFRS 9, *Financial Instruments*, that will enhance investor understanding, including a past-due aging analysis of amortized cost of debt instruments on non-accrual status; a disaggregated list of debt instruments on non-accrual status; and an explanation by financial class of significant changes in the collateral securing an entity's financial assets. IFRS 7, *Financial Instruments: Disclosures*, also requires disclosures with respect to the sensitivity of "Level 3" financial instruments for which fair values may be more subjective, hence leading to greater potential volatility in fair value movements.

- *Other disclosures*

Companies should be encouraged to provide additional information that facilitates an understanding of future cash flows. For example, disclosure of the underlying contractual cash flows for portfolios of financial instruments and loans would enable more informed decision making.

- *Presentation changes*

The Green Paper highlights research which indicates market-consistent valuation may encourage long-term investors to increase their risk exposure, provided the volatility is recognized outside profit and loss. There is already a precedent for this treatment under IFRS 9, whereby certain fair value gains and losses on equity and debt instruments are recognized in Other Comprehensive Income ("OCI") rather than in profit and loss. In an accounting sense, there is no obvious principle that drives the distinction between reflecting gains and losses in profit and loss or OCI. However, in practice reflecting gains and losses in OCI is often seen as a compromise to reflect longer term changes in value, which may not directly or immediately result in cash flows but which are value relevant, in equity. Consequently, if reflecting fair value movements in OCI can help encourage long-term investors to increase their risk exposure to equities, then it is worth assessing how the accounting framework under IFRS can be modified to accommodate this.

- *Regulatory capital*

Financial institutions that are required to maintain regulatory capital normally base their calculations on capital as presented in the financial statements, with further adjustments for intangible assets, haircuts on certain financial assets, etc. IAS 39, *Financial Instruments: Recognition and Measurement*, requires that certain financial instruments be presented at fair value. Short-term investor behaviour may reflect the uncertainty over a financial institution's ability to meet its minimum capital requirements and the impact of fair value accounting. Regulators should determine whether additional guidance and management disclosure is appropriate to address short-term market reaction to sudden market movements.

- *Actuarial determinations*

Pension plans normally perform at least annual actuarial valuations of their assets using point-in-time fair values against projected future funding requirements. EFAMA believes that funding models should consider a longer horizon for valuation of assets and for determining their expected returns.

Lastly, it is important to recognise that not all institutional investors are bound to present their financial statements in accordance with the IFRS principles and thus not all are affected by the fair value accounting.

21) What kind of incentives could help promote better long-term shareholder engagement?

EFAMA agrees with the Commission's analysis brought forward in its Green Papers on Corporate Governance in Financial Institutions and EU Corporate Governance Framework that lack of shareholder engagement has contributed to the financial crisis. EFAMA fully shares the Commission's analysis that better long term shareholder engagement would be desirable.
EFAMA understands that the Commission seeks to pursue two goals, namely first to encourage shareholders to more engagement and secondly to encourage this engagement to take place on a longer term.

Shareholder Engagement by institutional investors and asset managers

EFAMA considers that the engagement by institutional shareholders in target companies has increased in the last years throughout Europe. This engagement can take the form of active voting in shareholder meetings. In many cases, institutional shareholders or asset managers acting on their behalf also engage with target companies outside of shareholder meetings. Many of these interactions are conducted discreetly and outside of the public eye.

In the last years, institutional investors and asset managers have adopted and published engagement policies following international standards such as the EFAMA Code for External Governance, the UK Stewardship Code or UNPRI Principles. While in theory, shareholders have a natural interest in engaging with the companies that they own, in practice they often need to adopt a selective approach and prioritise engagement given the level of resource available. This is particularly true when spread across hundreds or indeed thousands of investments globally. Often only the most focused funds and listed turnaround vehicles, which often have highly concentrated portfolios and a relatively high level of resource per investment, can provide intense engagement. Criteria for the selection are laid down in the engagement policies.

Barriers to shareholder engagement

As mentioned above, shareholder engagement has already intensified since the financial crisis. Nevertheless EFAMA considers that there are still many barriers to shareholder engagement rendering engagement much more difficult for shareholders. These barriers include in particular inefficiencies in the nominee and intermediary chain between an issuer and the investors, i.e. inefficiencies in the "plumbing". Shareholder engagement could be facilitated by providing shareholders with a uniform toolkit across EU member states and eliminating impediments which prevent investors from exercising their existing rights such as blocking shares for voting. There are

also questions around the enforcement of stewardship codes. Furthermore, the transparency and accountability of voting agencies regarding their processes, rationales for their voting recommendations and conflicts of interests could be enhanced.

EFAMA understands that the Commission will seek to remedy certain of these inefficiencies with the actions taken under the Corporate Governance Action Plan.

Broadening of scope

EFAMA shares the Commission's view that shareholder engagement should still be improved. This being said, EFAMA considers that the enhanced participation of other stakeholders in target companies would also be beneficial. Accordingly, the EFAMA Code for External Governance does not limit its scope to engagement of shareholders in target companies but also addresses the engagement of bondholders in target companies. Institutional investors which hold important parts of the outstanding debt of a target company may also exercise important influence in such company and their role as "engaged bondholders" merits in our opinion consideration by the Commission.

Fostering long-term horizons

EFAMA understands that the Commission seeks long-term engagement from institutional investors. In addition to introducing incentives to encourage long-term engagement EFAMA would strongly suggest to reduce or remove the current incentives for short-term focus. There have been a number of reports and papers issued that provide suggested remedies to short-termism, a particular example is the Kay review which is being used in the UK and more widely as a blueprint for improvements.

In this context, the focus should not only be on actual shareholders of companies but also on other institutional investors participating through alternative equity instruments. Such instruments allow market participants to hold economic interests in the underlying share without the need actually to hold the share. Whilst there is value in derivatives as a way to hedge risk, too often these are used as an instrument of short-termism, including creating or benefiting from volatility, or as a way to have exposure to benefits of equity ownership without the associated costs, including tax, and responsibilities, such as voting.

EFAMA does not believe that changes to companies' share structure by introducing enhanced voting rights or dividends dependent on the length of ownership will lead to a material change to long-term engagement with companies. Rather these measures could well be counterproductive by entrenching a core group of shareholders to the detriment of minority shareholders. In addition the cost of monitoring and applying these provisions to share registers and underlying sub-registers would be significant for issuers at a time when the primary policy aim is to increase access to capital rather than raising the cost of capital. These issues also need to be taken into account in the forthcoming securities law legislation.

22) *How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?*

EFAMA welcomes that the Commission is acknowledging that asset managers are agents who act on behalf of their clients and upon clients’ instructions. EFAMA understands that the Commission agrees that the decision to select investment strategies (long-term or short-term) is taken by the institutional investors who then instruct their asset managers to act accordingly. The determination of the investment strategy depends on the financial profile/needs of the investor. If institutional investors want to have access to a certain level of liquidity, a portion of investments will be made in short-term liquid assets (e.g. monetary instruments). If investors are ready to accept a certain level of risk and illiquidity, they might expect higher performance provided they accept a longer duration of the underlying investments.

In other words, the behaviour of asset managers is driven to a significant extent by the demands of their clients and their advisers. EFAMA therefore considers that the interaction between asset owners and asset managers is key to the promotion of long-term shareholder engagement. The Commission is right to seek the alignment of the incentives of asset managers, investors and companies on long-term strategies.

EFAMA agrees that there are a number of practices that are currently common in the asset owner / manager interaction that reinforce a focus on the short term. These practices include the review of performance on a quarterly basis and the reporting of performance drivers on a quarterly basis. The almost continuous focus on short term movements by asset owners and their advisers lead asset managers to hold companies to account over more short term measures which are reinforced by the requirement for companies to issue quarterly interim management statements. The criteria on which performance and hence reward is based are still too often founded on excessively short-term measures.

Simple measures could be implemented to modify these criteria and to align these incentives, for example: fund manager performance could be reviewed over longer time horizons than the typical quarterly cycle. In this context, some EFAMA Members welcome the Commission’s review of the Directive on Transparency Requirements for Listed Companies and propose that the requirement to produce quarterly reports is lifted. Such short term reporting cycles can contribute to short-term thinking and discourage investment for the long-term, given the impact that could have on short-term performance. As long as quarterly reporting is mandatory for target companies, asset owners will in turn expect from asset managers a quarterly report on the entire portfolio.

Further examples include that pension funds could have voting and engagement policies that could be integrated into the investment process; shareowner activism could be given more weight in the selection and retention of fund managers and other matters; advisors to institutional investors could have a duty to proactively raise ESG issues; investment consultants’ fee structures should not reward them for moving clients between fund managers; and within companies the implementation of strong cultural norms could be supported by independent whistle blowing mechanisms, overseen by professional bodies who offer the whistle-blower appropriate protection.

There are a number of bodies who have issued suggested standard templates for mandates. These are often designed to ensure that there are incentives for asset managers to long-term strategies and relationships.

23) Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?

EFAMA considers that there is no need to revisit the definition of fiduciary duty in the context of long-term financing. The fiduciary relationship between asset managers and investors is not subject to a conclusive definition at the EU level. Rather, it is primarily a civil law concept which is founded on the agency agreement between the parties concerned. Accordingly, the rights and obligations of the fiduciary agency relationship are determined in the first place by the national civil law and jurisdiction by national courts. The existing frameworks of UCITS Directive, AIFMD and MiFID which lay down the supervisory requirements for the activities of asset managers can only indirectly impact the details of such rights and obligations, but cannot interfere with the general concept of fiduciary duty.

Within the framework of an asset manager-client relationship, the definition of fiduciary duty currently is and must remain the same independently of the strategy chosen. It is very difficult to imagine that fiduciary duty should have a different definition and content depending on the time horizon of the strategy chosen. The duties that a fiduciary is bound to deliver do not and should not alter because of the length of the investment outcome being sought or the length of the relationship that is to be in place.

EFAMA therefore considers that the definition of fiduciary duty should not be revisited in the context of long-term financing. In the chain of relationships between saver and investee company there are a number of relationships that require the delivery of a fiduciary duty, but this duty will not be driven by the length of the relationship.

24) To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?

The Commission's Action Plan on corporate governance and proposed amendments to the Accounting Directive will aid the provision of information investors need in order to engage with the capital they invest in for the long-term. In order to successfully invest in and engage with companies for the long-term, it is vital that investors are aware of all opportunities and risks, which necessarily includes environmental and social impacts as well as governance information.

In turn, greater integration of financial and non-financial information can help to provide a clearer view of a company's performance. However, the imposition of more regulations in terms of reporting information may serve to discourage some mid-cap companies from entering capital markets.

Given the cost of the process, however, EFAMA considers that six-monthly reporting of relevant instead of the current quarterly reporting would be preferable. Against this background the Commission should consider if the duties for AIFM to report quarterly to authorities (Art. 24 para. 1 and 3 Directive 2011/61/EU and Art. 110 para. 3 subpara. (b) and (c) Regulation 2013/231/EU create wrong incentives and solely bureaucracy and should be adjusted to a six-monthly reporting.

High quality, succinct narrative reporting should be encouraged. It is very difficult for any firm within the investment chain to demonstrate the value of non-financial information without widespread reporting on these areas by companies, in accordance with a consistent framework and standards. Information should be disclosed in an integrated manner with strategy, risk and performance in company's report and accounts and include information the culture and values of a company. Also, this ESG information must be voted on at companies AGM to ensure that it companies pay sufficient care to it. The purpose of corporate reporting is not merely to satisfy a need for transparency but to ensure that environmental, social and governance (ESG) issues are taken into consideration and embedded throughout all business operations.

25) Is there a need to develop specific long-term benchmarks?

EFAMA considers that there is no need to develop specific long-term benchmarks.

26) What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

EFAMA understands that the Commission aims for sources of financing for SMEs other than financing by banks which are currently unwilling or unable to fulfil this role.

The generic concept of SMEs covers an extremely broad range of business realities, with wide variation in Europe. In particular two types are relevant: (i) companies of a size and level of development sufficient to be able to access the capital markets directly, even if only for short-term financing, and which probably form the basis of the credit market; and (ii) all other companies which make up a very diverse group for whom an intermediary is essential to ensure the efficient evaluation and monitoring of loans. SMEs throughout Europe do not face the same financing problems. Financing is more difficult in Member States which are currently suffering more from the consequences of the financial crisis.

EFAMA understands that for all SMEs the Commission seeks access to capital markets without transferring the requirement to individually underwrite each of the borrowers to the end investor as this would not be feasible. Instead, the Commission seeks a way to provide access through a form of pooled investments.

One option would be securitisation of loans to SMEs. In a first instance banks will still need to act as originators for such securitisation. Securitisation of loans to SMEs requires simple, standardised tools

and information on the underlying assets, and statistics about the underlying broader situation which help to assess the relative merits of the different vehicles. The very pertinent need for liquidity requires minimum amounts of issue which may dictate the grouping of assets of different lenders, a situation which bears thinking about. Lenders must have economic incentives to free up space on their balance sheet, and investors should not be penalized for using these instruments given to alternatives such as bonds of financial institutions. Therefore in order to encourage more capital into this activity from new investors, it would be necessary to ensure that capital charges on SME financing products, such as SME ABS, are no different from the favourable treatment for products such as covered bonds. Divergent capital charges between these asset types are not justified, as there is more transparency on the pool of assets secured in SME ABS as compared to covered bonds.

As mentioned above credit markets are currently fragmented, with SMEs in those countries currently receiving financial assistance being more seriously affected than large-cap companies, and continually suffering from a shortage of liquidity. As such, there are not only problems of long-term financing for SMEs, but also liquidity problems. An additional measure could involve the development of a commercial paper market at European level, or platforms which handle short-term loans for SMEs. This type of measure would have to be based on clear rules regarding transparency of information concerning the business and their credit risk rating. This would have the effect of narrowing the gap in SME funding costs between different Member States.

Protection for SMEs through dedicated platforms with (low) costs shared are some of the suggestions which are on the right track. It would unreasonable to seek to improve conditions of accessibility and then entangle them in costly and bureaucratic processes which SMEs cannot afford.

Last, as far as equity investments are concerned in particular, one relevant aspect relates to a company's free-floating share capital, since in many cases, individuals or the original owners of family businesses have an aversion to the loss of corporate control. In this context, it is worth considering a greater role for hybrid instruments in corporate finance as a method of safeguarding a company's liquidity.

27) How could securitisation instruments for SMEs be designed? What are the best ways to use securitisation in order to mobilise financial intermediaries' capital for additional lending/investments to SMEs?

EFAMA considers that adequate securitisation instruments for SMEs exist already. The SME securitisation market will grow if it is correctly structured and originators have aligned interests. EFAMA sees several means which could help to re-activate the SME securitisation market in Europe:

A first important element is a well-designed and strict European regulatory framework to facilitate the return of investors. This includes the mitigation of conflicts of interest and the alignment of interests between originators and investors (5% "skin in the game" due diligence practices, fight against the dependence of the CRA). Further market transparency should be enhanced, for example through standardized documentation, concise and of quality, transparency on the standards used.

Standardization should be encouraged and complexity of products reduced. In this context a further element will be equal treatment between products with equivalent risk (in Solvency II, a senior ABS tranche with a collateral of 120% costs more in terms of capital requirements than a direct investment with 100% collateral). Effects of systemically relevant thresholds (transition of Investment Grade to Non-Investment Grade) should be reduced. It would also be important to recognize differences in prudential frameworks of entities (separate in the portfolios from insurances those linked with the savings business insurance life and those linked with the pension insurance).

Another important element could be public sector support which can also play a crucial role in reactivating the SME securitisation market. Examples mentioned in this context included KfW bank, the German government-owned development bank. This government-backed scheme has proven its effectiveness in channelling cheap funds to SMEs during the current economic downturn and represents a model that could be adopted successfully elsewhere. Examples of the approaches pursued include the promotion of the capital markets and the securitisation of SME loans. Through securitisation platforms it has helped commercial banks to transfer loan risks from SME portfolios to the capital markets, thereby giving credit institutions more scope to extend new SME loans. In cooperation with the Commission and the Council of Europe Development Bank (CEB), KfW also provides "Global Loans" to European commercial banks to help them finance SMEs on attractive terms. The public agency, which could be set up by the Banque Publique d'Investissement for a French program or the European Investment Bank for a project at the European level, would offer many advantages, including a guarantee for reducing risks for investors, a standardization of the form of loans and as well as their diversification according to predefined criteria will allow for significant cost reductions both for the structure and the intermediary, a capacity to act as a technical intermediary (rating system, experience, transition matrix, ...), a presence in the deal which could increase the appetite of investors, access to an important public banks, assistance to smaller institutions and reduces barriers to entry for securitization.

28) Would there be merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitised products specifically designed for SMEs' financing needs?

EFAMA is hesitant about the creation of a fully separate and distinct approach for the SME Market. The requisite structures already exist and EFAMA therefore does not believe that such an approach would be necessary.

29) Would an EU regulatory framework help or hinder the development of this alternative non-bank sources of finance for SMEs? What reforms could help support their continued growth?

No comment.

30) In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of the European economy?

A key factor for long-term financing of the European economy will be political and regulatory stability. Investors, both institutional and retail, remain hesitant to invest in an unstable, unpredictable and constantly changing environment. It is therefore of utmost importance and would already help a lot to avoid any burdensome measures that create uncertainty and irritations amongst European and foreign investors without any need and economic or fiscal benefit (such as the implementation of an FTT). The current political volatility, which, at least in some Member States, is turning structural investments of the past into white elephants, and the improvisational measures being taken in an effort to rescue those countries in financial difficulties are negating the commitments made upon accession, thereby undermining the confidence investors need to sustain in investment projects in the long term.

Brussels, 25 June 2013

[13-4022]

European Private Equity and Venture Capital Association (EVCA)

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CREATING LASTING VALUE

Executive Summary

The corporate governance and value creation model that private equity (including venture capital)[1] investors apply to the ownership and development of unlisted companies over the long term has earned it a position as a well-established investment strategy.

It is valued by the businesses and employees in whom it invests for the contribution it can make to their long-term prosperity, helping to deliver innovation, growth, renewed dynamism and sustainability. As an absolute return investment institutional investors value the important contribution it makes to the delivery of long-term returns necessary to meet their liabilities.

The Public Affairs Executive of the European Private Equity and Venture Capital industry welcomes the debate that the European Commission has initiated via its Green Paper

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[1] The term "private equity" is used in this paper to refer to all segments of the industry, including venture capital. The term "venture capital" is used in specific contexts where there are issues that relate particularly to this segment.

About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

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and the opportunity to outline the role that our industry can play in delivering smart, sustainable and inclusive growth that creates jobs and enhances the European Union's competitiveness for the long-term.

Securing long-term financing is a global challenge, and the private equity industry welcomes and is engaged in the policy debate that the G20 has initiated[2]. While there are a number of policy issues that could well benefit from a coordinated, global approach, there are a number of policy tools that are already in the hands of European policymakers. There are some concrete steps that the EU can take:

- the capital requirements that are applied to institutional investors when they invest in private equity should reflect accurately the characteristics of the asset class, particularly in Solvency II and IORP.
- in developing proposals to reform the structure of banking in Europe any changes to the existing relationship between private equity and banks should be considered carefully and not discriminate against private equity as an asset class
- EU funding should be provided for market-oriented venture capital funds-of-funds that can act as a genuine catalyst for private sector investment
- a new EU level fund structure should be created to encourage cross-border investment by removing the risk of double taxation and the current distortions that discourage investors from pooling their investments
- valuation and accounting methods should be developed that reflect better the characteristics of long-term asset classes such as private equity
- the private equity model of corporate governance, which delivers a close alignment of interests between investors and fund managers, and between fund managers and portfolio companies, should be promoted, and not undermined inadvertently through changes to the MiFID regime.

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[2] http://www.evca.eu/WorkArea/downloadasset.aspx?id=7696

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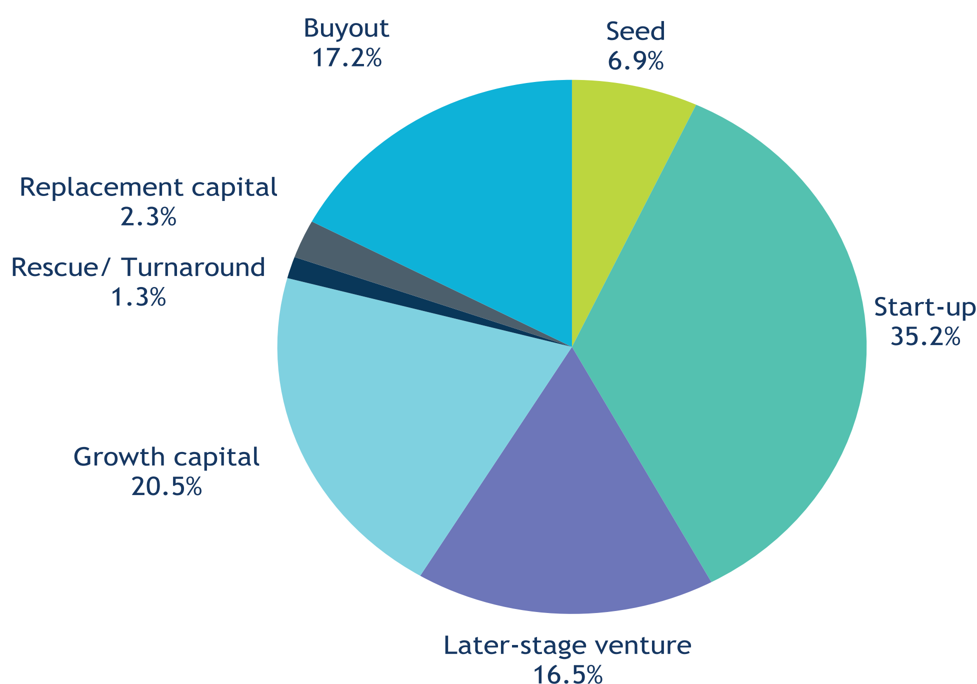
1. **The Private Equity Model: Delivering Value for the Long Term**

As the Green Paper recognizes, long term financing is "*needed throughout the whole lifecycle of a company, helping to start a business, allowing it to grow, and then sustaining its growth*[3]". Private equity reflects this through the contribution it makes across the different stages of business development. In 2012 alone private equity invested around €40bn in approximately 5,000 companies in Europe, across all of the stages of their development.

***Figure 1: Investment by Stage Focus – 2012*[4]**

% by Number of companies



Venture Capital	**2,923 companies**
Buyout	**878 companies**
Growth	**1,047 companies**

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[3] Green Paper, page 2

[4] Source: EVCA/PEREP_Analytics

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As the European Commission further develops its thinking on long-term financing it is essential that policy solutions are developed that will benefit companies of all sizes and at all stages of their development, from the smallest new endeavour, through to the largest well-established companies.

Particular attention should be given to ensuring that the needs of the mid-market sector are taken into account. These are companies that make a significant contribution to the European economy, supporting 32 million private sector jobs in Germany, France, Italy and the UK alone[5]. But whereas the smallest companies often benefit from specific public policy initiatives designed to facilitate their growth, and the largest companies have the scale and resources to deal with the impacts of regulation or with challenging macro-economic conditions, the mid-market may have neither of these advantages.

Private equity has a role to play here, given its strong track record of investing in companies of all sizes, providing support to start-ups, mid-market firms, and the largest companies. As Figure 2 illustrates, private equity invests in companies of all sizes, and so public policy that facilitates investment into this asset class will help a wide range of companies to develop, grow and create jobs.

[5] GE Capital: "The Mighty Middle: Why Europe's Future Rests on its Middle Market Companies" June 2012

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Figure 2 - Investment by Amount & Number of Companies - 2012[6]

Number of companies
2,000
1,800
1,600
1,400
1,200
1,000
800
600
400
200
0

€ million
10,000
9,000
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0

0 - 19: 137, 84, 1,403
20 - 99: 968, 2,025, 1,412
100 - 199: 1,125, 2,011, 307
200 - 249: 360, 1,258, 7
250 - 499: 523, 3,963, 30
500 - 999: 338, 4,743, 24
1000 - 4999: 324, 9,588, 2
5000 +: 33, 4,317, 0

SMEs
Number of full-time equivalent employees

Venture - Amount invested
Buyout - Amount invested
Growth - Amount invested
Venture - Number of companies
Buyout - Number of companies
Growth - Number of companies

Active Ownership for Long Term Growth

Private equity not only invests across all stages, it also invests in a broad range of industrial sectors (see Figure 3).

[6] Source: EVCA/PEREP_Analytics

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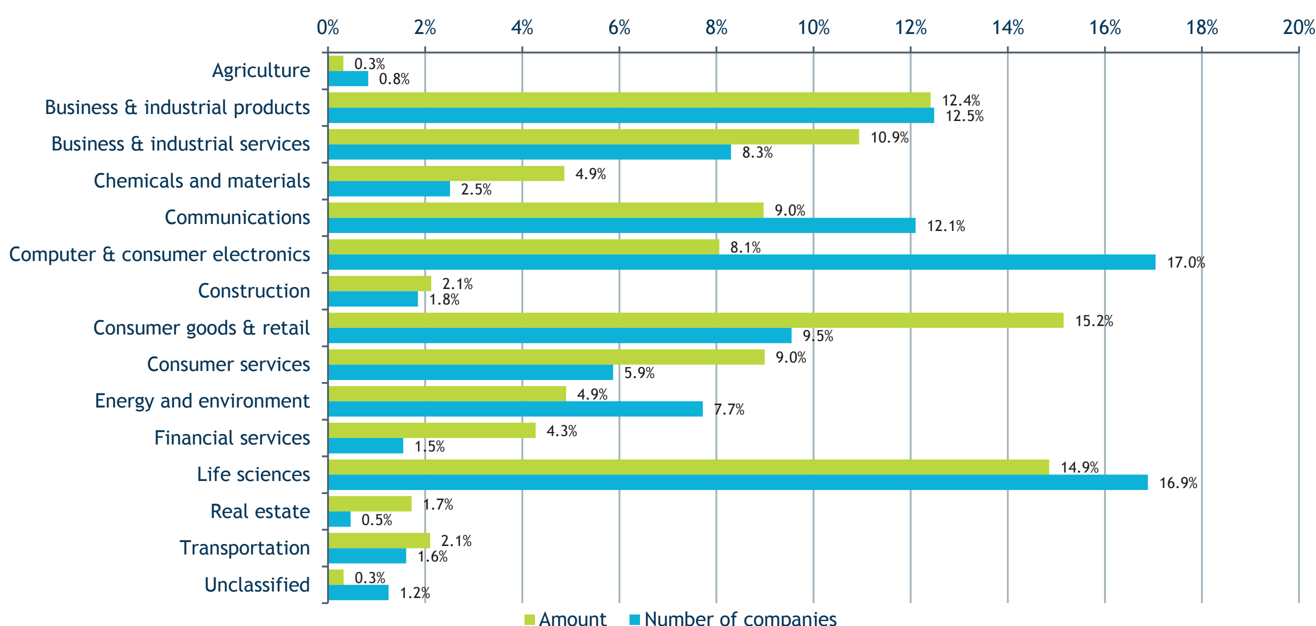
The precise contribution that private equity will make to a company will depend upon the stage at which it finds itself and even more so upon its unique characteristics and needs.

Figure 3: % of Total Amount Invested in Particular Sectors / No. of Companies - 2012 [7]



But regardless of the sector or the company's size or stage of development, private equity owners will become relatively long-term owners of the companies in which they invest, staying invested for an average of 5 years.

Their key contribution to the long term success of these companies comes not from the *duration* of the holding as such but from the *active* ownership of the companies in which they invest and the long term perspective this management brings. The private equity manager's role is to help develop the company in which an investment has been made, so that it is a sustainable business for the long term. This is done through the combination of financial investment and the investment of human capital in the form of business-building experience and knowledge. These are not passive, anonymous investments in securities traded on liquid markets, but patient and interventionist commitments to a company, its management and its employees.

Private equity does not seek indefinite ownership of the companies in which it invests, but rather seeks to ensure that these companies have a firm foundation for sustainable growth so that they are an attractive investment proposition for future owners and can continue to develop in the next phase of corporate life.

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[7] Source: EVCA/PEREP_Analytics

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This is a model that works. There is now compelling and consistent evidence of the variety of ways that private equity's model of active ownership can enhance companies' long term development, during their different stages and across functions:

- ***Innovation***: the Green Paper identifies[8] R&D and innovation as key forms of "long-lived capital goods". Private equity investments are notably successful at stimulating innovation and in particular contribute to a significant increase in patent filings[9]

- ***Growth***: private equity backing of companies can be an engine of growth for SMEs. They experience greater growth in sales, assets and employment than those not backed by a private equity fund[10]

- ***Access to Finance***: following a private equity majority investment, companies are typically able to increase their capital expenditure and become more profitable than their competitors[11]

- ***Secure***: private equity backed businesses are less likely to default than other companies (3% compared to 6%[12] during the 2008-2009 recession in Europe; the failure rate for private equity-backed companies is at least 5% lower than for similar publicly owned companies[13])

- ***Productivity:*** private equity investments in large European companies improved the latter's productivity by 7% per year[14]

- ***Operational Improvement:*** approximately 66% of the value created by private equity investments comes from operational improvement, in particular from sales growth, improved margins and freed up cash which then becomes available for, for example, value enhancing operational investments or debt repayments[15]

- ***Venture capital injects economic dynamism:*** an increase in venture capital investments of 0.1% of GDP is statistically associated with an increase in real GDP growth of 0.30 %. Early-stage investments have an even bigger impact of 0.96 %[16].

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[8] Green Paper, page 5

[9] Popov and Roosenboom., 2009, ECB Working Paper

[10] Boucly et al 2011., Journal of Financial Economics

[11] Boucly et al 2011., Journal of Financial Economics

[12] Thomas 2011., SSRN Working Paper

[13] Bank for International Settlements., 2008 Private Equity and Leveraged Finance Markets

[14] Ernst and Young., 2012

[15] Kaserer C., 2011, Return Attribution in Mid-Market Buy-Out Transactions

[16] Deutsche Bank Research, 2010

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- Venture capital-backed companies benefit from sales growth: Venture capital has an "unequivocally positive" impact on the productivity and growth of companies, particularly when investment is received at seed stage[17].

[17] VICO, 2011

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2. **Channelling Long-Term Financing to the European Economy**

As the Green Paper notes, a range of players must be engaged to channel pension and other savings and investments towards productive activities that will benefit the economy and deliver returns for investors. The private equity model is particularly successful at this.

Providing Investors With Lower Risk Access to Assets

Investing directly into unquoted companies is a highly-specialised area of investment. For most institutional investors the very broad range of skills and resources needed to invest effectively in such companies is difficult to develop in-house and often it is not consistent with the investor's broader business strategy to try to do so.

In these cases private equity funds managed by specialists perform a vital role in enabling investors to gain exposure in a diversified and low-risk manner.

Corporate Governance

The private equity manager not only provides expertise but also has a direct stake in the success of the funds. The private equity manager invests *directly*, alongside the institutional investors, in the fund, and, therefore, has a strong alignment of interests with its investors.

The Green Paper[18] highlights the importance of appropriate corporate governance arrangements in "aligning the incentives of asset managers, investors and companies on long-term strategies". The private equity model has many features that help to achieve this alignment.

The majority of institutional investors access private equity via 10-year, closed-end limited partnerships (or similar structures). The institutional investor becomes the 'limited partner', making a legally-binding commitment at the start of the fund's life to invest a defined amount into the fund without redemption rights. In addition, the private equity manager (or 'general partner') *also* invests directly into the fund, becoming a 'co-investor'. This ensures a clear and strong alignment of interest between the manager of the assets and the investors.

This alignment of interests is accentuated by the typical private equity model of return allocation which ensures that the investors in the fund receive *both* their invested capital *and* a pre-agreed level of return before the fund manager receives a share of the net profits generated from all of the investments in underlying companies that have been made. To be clear, in the typical private equity vehicle the manager's gains are linked directly to the *actual* return that investors receive over the whole life of the fund and across all the investments made.

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[18] Green paper, page 15

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Throughout the life of the relationship between the private equity manager and the investor mechanisms are put in place to help to ensure that these interests remain aligned and that investors are kept engaged. The 'Limited Partner Advisory Committee', for example, is an important mechanism through which investors are engaged actively in the governance of the fund.

Private equity owners also ensure that employees at all levels of the portfolio company are incentivized to participate in its development and to take the steps needed to help it to reach higher levels of performance.

The corporate governance approach that private equity delivers is effective in ensuring the alignment of interests at all levels and should be promoted. The private equity industry in Europe is concerned, however, that current proposals to revise the Market in Financial Instruments Directive (MiFID) could inadvertently undermine this model. While the plans to restrict the number of directorships that any individual can hold may have merits in other sectors, they are not appropriate for private equity. Private equity funds invest in a range of portfolio companies and will therefore rely on directorship agreements with advisors from investment firms. These agreements are at the heart of the active ownership that is central to private equity's success and may often require these advisors to sit on a number of companies' boards.

Reforms to corporate governance in MiFID should therefore take the specific characteristics of private equity fully into account. We therefore support the recent agreement reached by the Council on this issue, which has embedded the proportionality principle in the provisions on corporate governance and included some legitimate flexibility in the applications of the limit on the number of directorships that can be held by members of the management body of investment firms.

The Contribution of Specific Investor Groups

Private equity is an asset class that is trusted and valued by a broad range of investors. Between 2007 and 2012 European private equity funds attracted €264 billion of commitments[19]. As Figure 4 shows, pension funds provided approximately 25%, insurers 8% and 'funds of funds' 15% of that amount (with pension funds in particular providing a significant portion of the amount invested by 'funds of funds').

Private equity can be seen therefore as sitting at the centre of a network of financial sector institutions. It is able to bring investors together to deliver productive financing to the economy, and to companies that might otherwise face barriers in attracting such investors. The involvement of private equity in a portfolio company can also help to facilitate bank lending for its future development.

Furthermore, this network includes both EU and third country investors. Private equity has a strong track record of attracting foreign investment. The Green Paper recognises[20] that this can be an important source of financing for the long term. Some

[19] Commitments are funds that investors have agreed to provide to the private equity fund and will be drawn down over time as investments are made into specific portfolio companies.

[20] Green Paper, page 4

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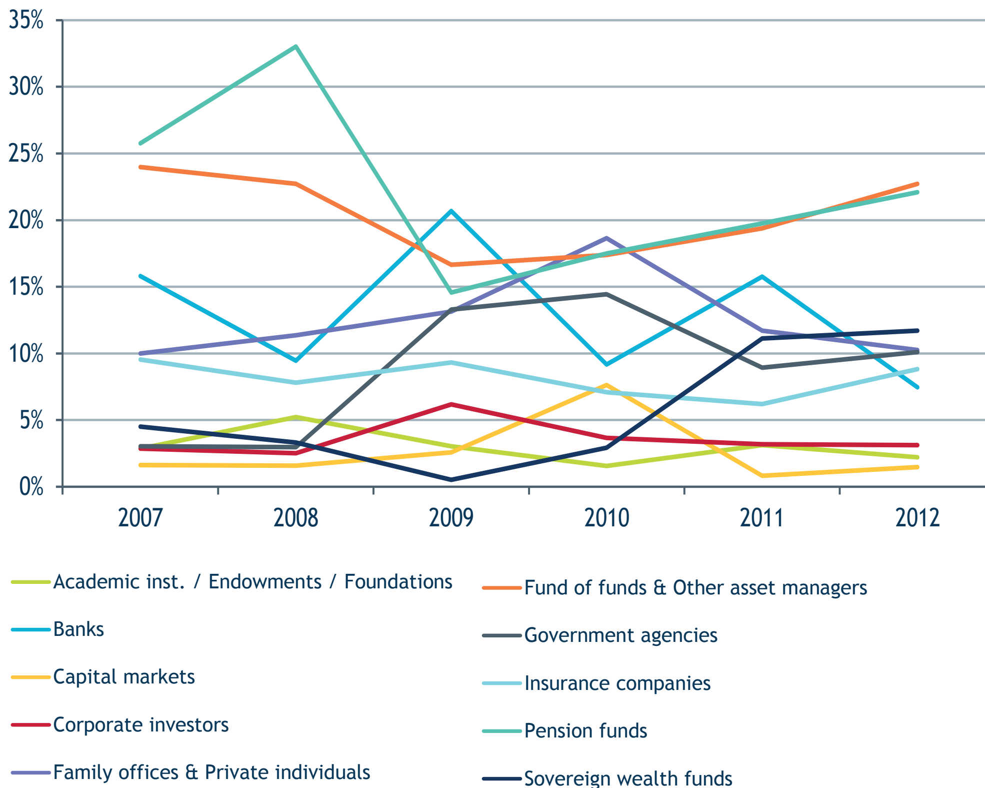
40% of the funds raised by EU 27 private equity funds during 2007-2012 were attracted from investors *outside* Europe. This is a significantly higher ratio of overseas investment[21] than for the European economy as a whole and demonstrates that private equity is an important mechanism for attracting much-needed third-country investment into Europe.

Figure 4 – Sources of Investment into European Private Equity[22]



The commitment that investors show to private equity is a reflection, ultimately, of the returns that it can deliver, which, as Figure 5 demonstrates, compare favourably to other asset classes. Investors – of whatever type – are charged by their clients with delivering returns and choose private equity because of this. These returns, in turn, flow back into the economy, generating further rounds of investment.

[21] Based on Eurostat data, from 2007-12 Foreign Direct Investment was 9% of total investment (FDI + Gross Fixed Capital Formation) in the EU 27; in comparison, 40% of the funds that European Union private equity funds raised came from outside the 27 Member States

[22] Source: EVCA/PEREP_Analytics

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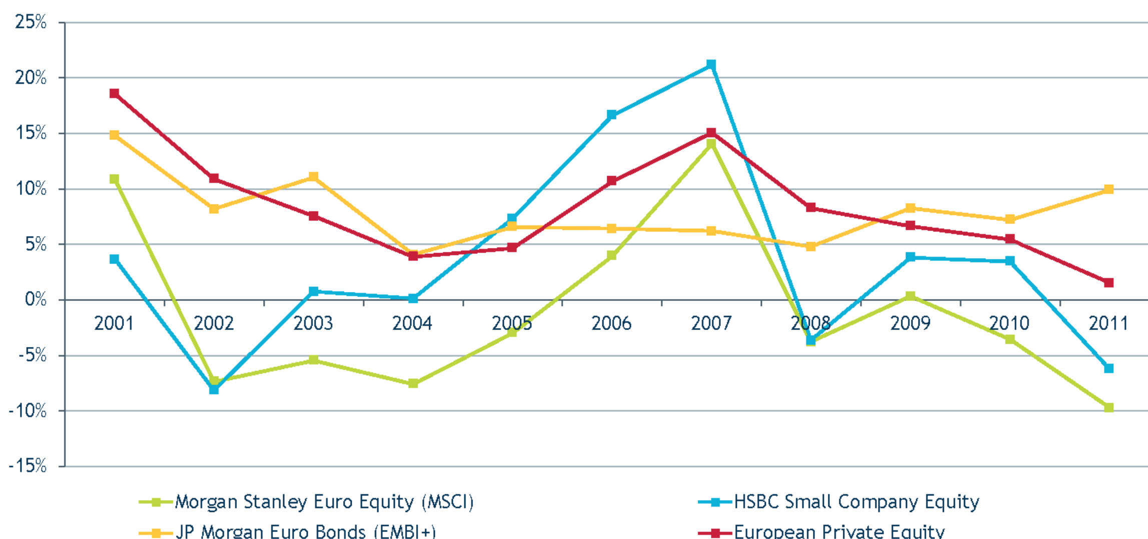
Figure 5 - Returns from Private Equity[23]



But as the Green Paper notes, each of these investor groups now face a new regulatory framework, which can raise specific challenges for their continued ability to provide long-term financing for the European economy.

(1) Commercial Banks

The commercial banking sector plays a variety of roles in the private equity industry, from investing in funds directly[24] on its own account or as an agent of clients, through to the provision of lending to assist specific private equity-backed portfolio companies in their growth and development.

The private equity industry is therefore closely following developments in banking sector reform, in order to ensure that an appropriate balance is struck between financial stability and the delivery of finance to the European economy, and particularly to SMEs.

The industry is particularly concerned to ensure that the debate on the structure of banking treats banks' relationships with private equity appropriately. The European Commission Services' recent consultation[25] on Reforming the Structure of the EU Banking Sector suggested that bank "exposures" to private equity should not be

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[23] Source: EVCA/PEREP_Analytics

[24] i.e. in effect becoming a 'limited partner' in an equivalent manner to other institutional investors

[25] 'Reforming the Structure of the EU Banking Sector', Consultation Paper of the Commission Services

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permitted within the deposit-taking entity, and should always be contained within the trading entity.

The consultation document provides no detailed analysis of the reasons for this conclusion, nor does it specify the types of exposure that banks might face to private equity that would merit their permanent exclusion from any deposit-taking entity. Although the 'Frequently Asked Questions' document that was released subsequently provided some further information a significant degree of uncertainty remains.

We believe that the nature and scale of the risks that a bank would be "exposed" to from private equity would not justify a blanket exclusion of all such activity from the deposit-taking entity, not least because equivalent exposures from other ownership models do not seem to be treated in this way.

Our response to the Services' consultation will explain the reasons for this in further detail.

(2) National and Multilateral Development Banks

Development banks have a potentially important role to play in encouraging investment, and as the Green Paper notes[26] this should be to "catalyse" – rather than "crowd out" - private finance. Public money must be deployed in a way that will encourage new private sector participants without becoming a substitute for such financing.

European venture capital could particularly benefit from the targeted deployment of public funding from Horizon 2020 and COSME, and we share the Green Paper's assessment of the challenges it faces[27]. As institutional investors face disincentives to invest in venture capital (see below) there is a danger that Europe loses a vital mechanism to invest in and to develop the innovative companies that will contribute to growth over the long term.

Money from the EU budget could help to catalyse new private investment by creating a programme of targeted public participation in private sector-led 'funds of funds'. Under this model experienced fund of funds managers that have existing relationships with venture capital fund managers and an established global network of private sector investments would be tasked with raising private money to match EU funding.

EU money would act as a corner stone, being matched by investment from private sector institutional investors, but with normal private sector disciplines being applied (for example to the choice of funds – and thereby ultimately companies - into which investments will be made). Over time this would help to develop a broad-based European venture capital sector in which the private sector could play an ever-larger role.

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[26] Green Paper page 7

[27] Green Paper, page 16: "The venture capital sector suffers from lack of resources and is influenced by bank and insurance prudential regulation"

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We therefore encourage the European Commission – and the other Institutions – to conclude negotiations on the Horizon 2020 and COSME programmes as soon as possible, and to use €600 million[28] of that funding to develop private sector-led funds of funds.

The provision of public money also requires an appropriate state aid regime and European venture capital could benefit from ongoing efforts at modernization in this area[29], as part of a broad review of state aid rules[30]. State aid enforcement should contribute to sustainable, smart and inclusive growth, focus on cases with the biggest impact on the single market and streamline the rules and provide for faster, better informed and more robust decisions.

More specifically, by allowing a greater number of risk finance measures under the General Block Exemption Regulation (GBER) to be exempted from the notification requirement, and by better reflecting the size of market failure in the relevant thresholds in the GBER and new Risk Capital Guidelines, the Commission would contribute to the reduction of red-tape, allow more flexibility for timely investments and maximize the impact of private sector capital. It is important to ensure that the final and updated legal framework for state aid contributes to and facilitates the deployment of public and of private capital, to the ultimate benefit of the European economy.

(3) Institutional Investors

As Figure 3 (see above) demonstrates, pension funds and insurers are significant investors in private equity, recognizing the particular benefits that it can bring.

It is a long term asset that fits with the time horizons of many such investors and, critically, it is able to deliver above-inflation returns (see Figure 4). Pension funds, for example, need assets that are long term in nature, match the profile of their liabilities, and which deliver the real returns that are needed to ensure that those liabilities can be met as they fall due.

Private equity also has a role to play in enabling institutional investors to diversify and manage the risks that they face. By investing in a range of private equity funds, which are diversified by manager, stage of investment, geography and vintage year in which the fund is raised, investors are able to gain diversified access to a broad range of sectors of the economy, many of which are not available through public equity investing.

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[28] Based on EVCA market analysis: there is a market need and capacity for three funds of funds over 2014 – 2020 budget period with 100% matching capital from the private sector

[29] Commission Communication, State Aid Modernisation (SAM), 8 May 2012, COM(2012)209 final.

[30] The Commission is, in particular, reviewing the General Block Exemption Regulation, as well as the Research & Development & Innovation Guidelines, and the Risk Capital Guidelines. The updated rules will apply from the 1st of January 2014.

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Moreover, the typical diversified portfolio of funds, through which investors gain exposure to private equity, gives exposure to investments over the whole economic cycle, so helping to mitigate the risks from shorter-term fluctuations in market conditions.

But even with these benefits, such investment will only flow to private equity if the regulatory environment encourages them to do so (or at the very least does not actively discourage them from investing). The Green Paper rightly notes[31] the importance of the discussion on "how to ensure that regulatory asset risk capital charges do not weigh overly on the holding of long term assets".

We welcome the recent announcement by European Commissioner for the Internal Market and Services, Michel Barnier, that the Commission will not pursue new prudential regulatory standards for pension schemes in the forthcoming review of the Directive on Institutions for Occupational Retirement Provision (IORP). This delay will provide further opportunity for analysis and reflection on the correct approach.

However, significant concerns remain about Solvency II and the risk calibrations for a number of long term asset classes, including private equity. Recent evidence[32] from the EVCA suggests that if the current risk calibration of 49% is applied to insurance firms then up to 50% of insurers with *current* private equity and venture capital programmes could significantly reduce their commitments. And some have *already* reduced (or put on hold) their investment into European companies through private equity, in anticipation of the new rules coming into force.

We have supplied research[33] to both EIOPA and the European Commission that details a more appropriate method based on databases commonly used in the private equity industry to calculate a risk calibration for private equity under Solvency II.

Without amendment to the Level 2 implementing measures currently being considered for Solvency II the long-term financing of SMEs via private equity – and other forms of investment – is at risk.

Long Term Investment Funds

The Green Paper[34] also notes the European Commission's intention to bring forward proposals for Long Term Investment Funds (LTIFs). The private equity and venture capital industry looks forward to participating in the debate around these proposals as they are developed by the Commission and negotiated by the co-legislators.

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[31] Green Paper page 9

[32] http://www.evca.eu/uploadedfiles/EVCA_response_EIOPA_discussion_paper.pdf

[33] http://www.evca.eu/uploadedFiles/Home/Political_Advocacy/Public_Policy/12-05-18_EVCA_researchpaper_PE_S2riskcalibration.pdf

[34] Green Paper page 10

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We share the Commission's assessment that fund vehicles can be a valuable mechanism to enable investors to get access to a wider range of assets and investment and to the expertise of fund managers with deeper knowledge of particular sectors. This is at the core of the private equity model (see above) and could be applied more broadly. Institutional investors with long term liabilities to meet, such as pension funds and insurers, are already using private equity, precisely because of these benefits.

As proposals for a new fund vehicle are developed the Commission, European Parliament, and Council will need to consider carefully the range of eligible assets and eligible fund providers to ensure that they are not unduly narrow. The policy framework for long term investment needs to range broadly and not be limited by type of asset, or by an arbitrarily chosen maturity. As far as possible the market should be allowed to develop solutions that meet the needs of investors and of those European companies and projects into which the investment will flow.

For example, these funds should be free to invest in companies of different sizes, and be given the flexibility to invest in companies through the provision of equity and/or the provision of mezzanine or junior credit. It is important that the discussion on long term financing considers companies' requirements for both equity investment and credit.

Some fund managers have now created separate funds which, like their traditional private equity funds, invest on a long term basis, but through debt, rather than equity[35].

In developing an EU LTIF framework, consideration should also be given to the impact that different tax regimes in EU Member States could have (see below – page 18) on the ability of these funds to attract cross-border (and third country) investment.

<u>The Combined Effects of Regulatory Reform</u>

The Green Paper[36] raises an essential question about the impact of regulatory changes and "*whether their cumulative impact…could be greater than the simple sum of effects of each reform taken in isolation*".

For private equity there is a very real concern that the combined effect of new prudential capital, liquidity and structural requirements on the banking, insurance and (potentially in future) pension sectors will significantly discourage investment in the

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[35] One way this investment can be delivered is by the issuing of new loans to portfolio companies, which can be of value to those finding it difficult to source credit from the banking sector. Each investment by the fund through the provision of debt is separate and self-contained, with no cross-collateralisation between the investments being made, and with no recourse to the fund itself. To the extent that such funds are closed-ended with no redemption rights, have a long-term investment strategy and do not use leverage at the fund level (i.e. the loans are funded by the equity that investors have contributed to the fund) they do not create systemic risk and could be seen as equivalent to traditional private equity investment

[36] Green Paper, page 11

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sector. The private equity industry would thus be impeded in its ability to perform its role in the European economy and be constrained from helping institutional investors to channel the savings and investment of their clients directly into European companies.

We would strongly encourage the European Commission to undertake a comprehensive assessment of the cumulative impact of post-crisis financial market reform to ensure that its implications are been fully understood and any unintended consequences identified. For example, with the entry into force of the Alternative Investment Fund Managers Directive there is likely to be an increasing tendency to cross-refer to this Directive in other pieces of EU legislation. This creates a risk that new obligations are imposed in an undifferentiated way to all of those entities covered by AIFMD, without due attention being given to the specific characteristics of private equity. The application of the revised 'professional investor' definition in MiFID to private equity in a way that is inappropriate to the industry's structure is one example of this.

The case for reform in the light of the financial crisis was unquestionable, but as we come towards the end of this mandate it is appropriate that the EU Institutions reflect on the cumulative impacts of this reform agenda.

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3. Cross Cutting Factors

Promoting Long-Term Savings by Households

The Green Paper notes correctly[37] that there is significant potential for households to contribute to the provision of long term financing for the European economy, and in a number of Member States government initiatives are already in place to encourage long term savings.

An EU policy framework for such initiatives could bring benefits. Retail clients would enjoy consistent protection and terms and conditions across the single market; financial institutions would be better able to develop uniform long-term savings products with economies-of-scale benefits; and a pool of additional long-term financing could be created that could be invested across Europe without discrimination or preference for national projects.

But developing such a new vehicle would not be without its challenges. Retail investors would need to be comfortable with the illiquidity and the broader risk profile of investing in such a vehicle. And a key feature of the attractiveness and success of such a savings vehicle would be its tax treatment, and the challenges of securing consensus amongst EU Member States on this element should not be underestimated.

In considering such initiatives EU policymakers will also need to assess thoroughly the potential implications of the creation of a new investment vehicle on providers of *existing*, long-term products, such as pension funds and insurers, who are already key providers of long term investment to the European economy. The goal of any new vehicle must be to enlarge the overall volume of investment being undertaken for the long term, and not simply to relocate it from one vehicle or product to another.

Taxation

Many of the tax issues that can impact on the willingness of investors to provide long term investment are dealt with currently by Member State authorities, rather than at EU level and there is considerable scope for reform in this area. Member States could, for example, choose to incentivise the re-investment of returns by offering the deferral of tax due provided a new investment is made for a specified holding period and / or in appropriate, eligible assets.

Notwithstanding the importance of Member State policy, we believe that there is also a role for the European Commission in helping to promote reforms to tax policy that will encourage investment.

[37] Green Paper, page 13

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In addition to enabling Member States to learn from each other, we believe that there are concrete legal initiatives that should be taken at the EU level in order to promote the flow of investment for the long term.

Fund Structures

The Green Paper endorses the benefits that the use of fund structures can offer. Such structures bring together investors with capital to deploy, companies needing resources to grow and develop, and professional fund managers who, in the private equity model, offer active support in order to maximize the benefits for the portfolio company and the investor. Although much of that capital can come from the extensive savings generated within the domestic economy Europe should also look to access the extensive global pools of capital that are available.

Private equity is already very successful in attracting investment from third counties (see page 11), but tax rules – both at the Member State level and internationally – can act as a disincentive to such cross-border investment.

Investing via a fund structure will often involve individuals or entities in a number of jurisdictions. For example:

- the country in which the investor(s) are located;
- the country of the fund's establishment; and
- the country (or countries) in which the portfolio company is located

But income and gains emerging from an investment can be treated differently by the different tax authorities involved, and even where there are double tax treaties in place these effects may not be mitigated.

The complexity and uncertainty that this creates acts as a significant potential disincentive to investment across borders, both internationally and even within the EU single market.

Moreover, tax regimes sometimes treat investors' returns differently depending on whether they invest *directly* into a listed company or *indirectly*, including via a fund structure. Such indirect investments can be treated *less* favourably, which acts as an impediment to the development of funds as a mechanism for channelling the pool of available savings to productive uses. And if the investor is not able or willing to make a direct investment (perhaps due to a lack of in-house expertise and a preference as a result to use an external manager's experience) the end-result could be that the investment is simply not made.

There are a number of initiatives that we believe could be taken at EU level to address this. The European Commission's Tax Policy Group, for example, could be used as an initial forum for Member States to discuss these issues, with a view to a consensus emerging on the reforms to their national tax regimes that might be necessary and a commitment to their implementation.

But we believe that there is scope for greater ambition and for the European Commission to take more decisive, legislative, action to support the Single Market and

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to remove disincentives for institutional investors to invest via fund structures. This could be done most appropriately by legislation to create a pan-European fund vehicle that would remove discriminatory tax treatment and the risk of double taxation and provide certainty and clarity about tax treatment of the instrument, and thereby encourage investors to use the fund model.

Further detail on how this instrument might work is provided in Annex I below.

VAT Treatment of Management Services

Any model of investing that uses a fund structure will generate a need for management services. Such services are, however, subject to very different VAT treatment across the EU Member States[38], which can create a compliance burden as investors are forced to understand a range of different tax regimes, and can distort decision-making and create an uneven playing field.

Ensuring consistent VAT treatment of management services would therefore support the Single Market and remove a potential distortion of location decisions, and could be achieved by non-legislative means (for example, through cooperation amongst Member States to agree on a common VAT treatment) or, if necessary, via amendment to EU VAT law.

Accounting Principles & Long Term Investment

The private equity industry endorses the Green Paper's assessment[39] that there is "merit in examining further whether [reporting] standards are fit for purpose when it comes to long term investment".

Private equity is a long term investment strategy, and fund structures are designed to reflect this. Private equity is not designed to be traded like a listed, liquid asset, and investors commit to the fund for its life – usually 10 years - and enter into an agreement that they will not withdraw from it during this period.

This structure is designed to ensure that the underlying companies in which investments are made have time to develop and to reach their potential. It removes the pressure for short term returns and encourages a focus on building the portfolio company for the long term.

Given this long term focus it is essential that appropriate methods for valuing investments into private equity are found and then incorporated into prudential regulation. If this is not done, and if there is too great a reliance on methods that over-state the risk associated with short term fluctuations in the apparent value of assets that are clearly to be held for the long term, then investment risks being discouraged.

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[38] For example, in some countries there is no VAT on management services and no VAT deduction on input VAT; others apply full VAT to management services and full deduction of input VAT; and there are many other variations between these two positions, such as different tests to determine the deductibility of VAT

[39] Green Paper page 15

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These short-term fluctuations are unlikely to be meaningful to the investor, who enters into a fund knowing that it is an illiquid, decade-long investment and is most interested in the total level of return that the fund will deliver over its life. But if they drive (excessive) capital requirements nonetheless, the investor will face disincentives to allocate its resources to this asset class.

Valuations in private equity companies are generally made according to the International Private Equity and Venture Capital Valuation Guidelines. These guidelines are compliant with IFRS standards on 'Fair Value', and have been developed to incorporate global accountancy standards. It is through the use of these Guidelines that investors are able to derive the Net Asset Value (NAV) of funds in which they invest.

The NAV of the private equity fund or portfolio of private equity funds is a 'best-efforts' attempt to put a market-like, fair value on assets in which there is no market. It gives a quantitative indication of the progress of underlying unquoted investments. These values are mark-to-market, or often in the case of private equity, mark-to-model accounting values and not market values in the traditional sense used in public equity investing. By definition the underlying investments are not traded on any market, hence there is no real market value. These calculated interim valuations and movements in the stated NAV can, however, play a role in the balance sheet of some institutional investors.

It is important in measuring risk in long-term, illiquid assets, including private equity, to capture the real risks that investors face, including:

- **Liquidity and funding risk:** the risk that the investor cannot meet its obligations to pay draw downs on a commitment as they fall due.

- **Long-Term default risk:** the risk that the investor loses capital with its private equity investment over the entire lifetime of the product ("Hold to maturity").

In any long-term closed end fund with no redemption rights, a measurement of the ratio of total capital paid into total capital paid out, will capture both the long-term default risk and liquidity and funding risk. We have previously set out an approach to deliver this in our research paper "Calibration of Risk and Correlation in Private Equity.[40]"

We encourage the European Commission to take this approach when developing prudential regulation for insurance companies, pension funds and banks with investments in long-term investment funds such as private equity, venture capital, property or infrastructure.

[40] http://www.evca.eu/uploadedFiles/Home/Political_Advocacy/Public_Policy/12-05-18_EVCA_researchpaper_PE_S2riskcalibration.pdf

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Conclusions

Private equity is a comparatively long term asset class. Investors commit to a fund for ten years as part of a strategy to deliver long term returns and to match long term liabilities. Portfolio companies receive committed investment for an average of five years, far longer than the average holding of the passive investor in listed equities. And the wider European economy enjoys the benefits of the innovation and growth that flow from active ownership, beyond the specific period that private equity was invested in a particular portfolio company.

Private equity is already making its contribution to Europe's economic future and is ready to do more. EU policy will have a vital influence on its ability to do so. This could be through the positive contribution that would come from, for example, the creation of a new fund structure that avoids distortions from the tax system that discourage investment. Or this influence could be negative, emerging from the (unintended) consequences that will emerge if specific pieces of regulation on capital requirements or the structure of banking, for example, fail to treat private equity appropriately.

The European private equity industry believes that it is not only possible but essential that the EU finds a way to deliver high prudential standards in the financial sector without sacrificing the capacity of the economy to create jobs and to grow. The long term investment framework can be an invaluable means of framing this debate and private equity will continue to play its part.

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Annex 1

Tax Obstacles to Institutional Investment into Private Equity in the EU

Investors face tax obstacles to investing in European companies via private equity.

The risk of double taxation makes investing in private companies through a private equity co-investment structure *less* attractive than investing in listed companies or even investing directly in a private company.

This amounts to a tax-induced distortion of investment decisions which could be removed by creating a new pan-European vehicle.

The Issue

A range of factors can impact on the ability and willingness of European private equity to operate across the EU single market, including language barriers, a preference to invest close to home to facilitate active ownership in the portfolio company, and potential differences in regulatory requirements.

But a key reason is the impact of 27 different tax regimes, which can force many smaller funds to restrict their fundraising and investment activity to their domestic markets. In so doing they miss out on investment opportunities in their target economic sectors in other Member States, which in turn limits the potential returns for investors, undermines the single market and the efficient allocation of capital, and prevents particular companies from receiving potential investment.

Although many EU Member States (MS) have agreed bilateral double taxation conventions based on the OECD's Model, the structures put in place by private equity to facilitate co-investment and management of unlisted companies are not always accommodated by these Conventions.

Private Equity: a Cross-Border Industry

It is not unusual for at least three countries to be involved in an investment:

- the country of establishment of the fund;
- the country(ies) of residence of the investors in that fund; and
- the country(ies) in which the portfolio companies are located

This can result in taxable income and gains being attributed and treated differently.

The application of any tax treaty between the *source* country of income and the *residence* country of investor is often uncertain and the withholding tax applied at source may end up as a liability for the investor.

The distribution of proceeds by the fund from the sale of shares to non-resident investors may face dividend withholding taxation, even though the investor's country of residence treats the distribution as capital gain and disallows credit for any such withholding tax.

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The mutual agreement procedures provided in double tax treaties might enable the elimination of difference in classification and eventual unjustified tax consequences but the procedure is time-consuming and administratively burdensome. Again, this double taxation may place the final burden on the investor and potentially impose a cost on investor groups such as pension funds that are not able to offset this tax against other tax liabilities.

Ensuring Equivalent Treatment to Other Investment Approaches

Equally important is the fact that private equity fund managers are treated *less* favourably than fund managers in public equities.

The activities of the latter are regarded as those of independent agents and not as 'permanently established' fund entities in each country of investment.

Private equity fund managers, however, face the risk that their funds – and indeed the investors in those funds - *are* seen as 'permanently established' in one or several countries, as some countries still consider the activities of funds as a business enterprise.

This can produce a tax liability in those countries in which funds have activities or in which the portfolio companies are located, and increases the prospects of double taxation.

Even if the fund is established as a tax transparent entity in its *home* jurisdiction - and does not therefore trigger a permanent establishment for the foreign investors - there could still be a tax problem if *other* countries do not regard the fund in the same way.

If, for example, the authorities in the jurisdiction in which the *portfolio company* is located do not accept that the fund making the investment is tax transparent a tax liability could be created for the fund that is *greater* than the aggregate tax liability of all of those investing in the fund.

There should be no difference in the tax treatment of investors holding shares in listed or unlisted companies.

When holding shares in a listed company the investor is only taxed in its *home* country upon sale of these shares. The same should apply when (holding and) selling unlisted shares *and* also when such unlisted shares are held through some sort of co-ownership arrangement (e.g. limited partnership).

As the Green Paper notes, the use of fund vehicles can help in facilitating the raising of capital and in helping institutional investors to diversify and spread risks. But tax neutrality is needed for the fund vehicle, and this needs to be recognized *both* by the countries where the fund is managed *and* where it invests to avoid investors being treated as having a permanent establishment in these countries, and to avoid the fund itself (which merely is a co-investment arrangement) being treated as a separate legal entity.

The larger and more cross-border the private equity firm, the greater the tax and legal resources required for funds and investors to understand the implications. But for

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smaller firms, especially in the venture sector, which do not have these resources but still seek to operate internationally, these issues are a real potential constraint on growth.

Recommendations

There is a significant amount that MSs could do through amendment to their national tax law, for example to ensure that fund structures do not trigger a 'permanent establishment'.

But in addition the European Commission could propose a legislative framework to create a pan-European fund vehicle for private equity and venture capital investment funds, alongside existing national structures. This EU fund structure would permit all EU and international investors to invest freely in private equity and venture capital across Europe, eliminating both the risk of double taxation and the existing distortions that discourage investors from accessing the benefits that can come from investing via a fund structure.

It would ensure that investors via funds were (like those investing via other routes) subject to full tax in their respective home jurisdictions, but not to double taxation.

Technical parameters

Such an EU-level fund structure would need to cover, inter alia:

1. *Tax transparency*

The most appropriate tax structure for investments in private equity and venture capital is one based on the principle of tax transparency. It is necessary to prevent double taxation: first, at the fund level, when the fund receives income or realises an investment; and second, when an investor receives income or capital from the fund.

Tax transparency ensures investors are subject to tax in their home jurisdictions, just as they would be when investing directly in company shares. Investors should not be in a worse position investing in unlisted companies through a fund than they would have been if they invested directly in the underlying companies or in listed shares.

2. *A fund structure suitable for international investors or for investors in other countries*

Some MSs, may charge tax on capital gains made by non-residents. Therefore, a suitable international fund structure should ideally be transparent, in order to prevent double taxation of non-EU investors looking to invest in European companies via a private equity funds structure.

3. *Clarity on permanent establishment*

The fund structure should not create a new permanent establishment in the country or countries in which the management or advisory team operates, or in which investments are made.

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4. *No VAT to be levied on the management charge*

Value Added Tax (VAT) should not be payable on management charges.

5. *No undue restriction on the type of investments that can be made*

Such a fund structure should not place undue restrictions on the type of investments that the private equity firm can undertake. Once the structure is in place there should be flexibility for market participants to determine the precise assets into which investments will be made.

Insurance Europe

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Position Paper

Insurance Europe welcomes the European Commission's Green Paper on long-term financing of the European economy and the opportunity to contribute to it.

Part I: Key messages of the insurance industry

Insurers' primary role is to provide protection, as well as long-term savings and pension products

- The primary role of the insurance industry is to provide protection, risk transfer and management of savings for retirement. Insurance promotes economic activity by giving policyholders risk coverage and implicit confidence to make investments or engage in business that they might otherwise deem too risky. Insurers are important suppliers of long-term savings and pension products which provide people with an income in retirement. These products are of increasing importance as state pension schemes come under strain from ageing populations.

Provision of long-term financing is not insurers' main objective, but a consequence of their primary role as providers of long-term products

- Insurers must invest the premiums they collect from policyholders to pay claims and benefits on their policies and to cover their operating and capital costs.
- While insurers can help support economic growth, policymakers should be aware of the fact that insurers' investment in long-term assets is a natural consequence of their liabilities, ie investing in assets is not an aim *per se*, but a consequence of insurers' primary role of providing protection and managing policyholders' savings.
- Insurers are the largest institutional investors in Europe (with €8.5trn assets under management at the end of 2012, up from €7.7trn at the end of 2011).

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Insurance Europe upholds that the intention and the capacity to hold assets over the long-term are the key features of any definition of long-term investment

- Insurance Europe appreciates the wide scope of the definition of long-term investing proposed in the Commission staff working document. Having the capacity to hold assets over the longer term is a key characteristic of long-term investors.
- It is important to recognise that long-term investment is not only about infrastructure, but also covers a range of other assets including, potentially, sovereign bonds, corporate bonds, equity, venture capital, property, covered bonds and securitisations.

Insurers' capacity to channel premiums towards long-term finance could be threatened by a range of framework conditions

- As the Green Paper recognises, a range of regulatory developments have the potential to affect insurers' ability to continue providing long-term funding to the economy. These concerns arise in a range of areas of policy, such as: prudential regulation, taxation, collateral requirements for derivatives, accounting rules and principles, macroeconomic policy, etc.

Regulatory initiatives should aim to create the best regulatory environment and framework conditions for market mechanisms to function correctly

- Any regulatory change and/or initiative should recognise that market mechanisms are unbeatable in allocating capital most efficiently.
- The availability of long-term investments is crucial for the insurance industry, as it is needed for matching liabilities and for enabling efficient risk management. This ultimately benefits policyholders.

Insurance Europe strongly supports the Green Paper assessment that, alongside institutional investors, well-functioning and deep capital markets and infrastructure are needed

- Stable, deep and liquid capital markets are essential for long term finance.
- Policymakers need to continue to support the development of corporate bond and equity markets across the EU.

In future, impact assessments should consider both the individual effect of regulatory developments and the cumulative impact of regulatory changes within and across sectors

- Ongoing regulatory reforms and changes should be continuously monitored and reassessed in order to address and limit any adverse impact on long-term investments.

The need to ensure financial and regulatory stability across EU member states

- Regulatory consistency and stability across member states would foster an environment in which those with capital would be more inclined to invest with a long-term perspective.

The European insurance industry greatly welcomes the EC's Green Paper on long-term financing of the European economy and will continue to support efforts to ensure that regulation and other framework conditions work as intended. Insurance Europe stands ready to continue the dialogue on these matters so that current impediments to long-term financing are removed in an appropriate way.

Part II: Responses to specific questions raised in the consultation

Over recent years, Insurance Europe highlighted the important role that insurers play as long-term investors in the economy and has raised a number of concerns about the extent to which regulatory developments can hurt this role. Such concerns are now being echoed not only within Europe but also around the world (by the G-20 or the Group of Thirty). These concerns prompted Insurance Europe to produce — together with consultancy Oliver Wyman — a report on the role of insurers as institutional investors. Entitled "Funding the future: Insurers' role as institutional investors"[1], the report was published in June 2013.

1. ***Do you agree with the analysis above regarding the supply and characteristics of long-term financing?***

Broadly, yes.

Insurance Europe agrees that governments and corporates are key players in long-term investments. However, the ability of governments to provide long-term financing in the future is in our view limited. Public debt in the euro area increased substantially after the global banking and economic crisis. The high level of public debt represents a burden for many governments restricting their long-term policy options already significantly and, instead, making it necessary for governments to consolidate their budgets. Therefore, from our point of view, households as well as financial intermediaries gain increasing importance in long-term financing, and will increasingly take on the role of providing both the corporate and the public sector with appropriate funding.

We agree with the view stated in the Commission's staff working paper that it should be recognised that long-term investment needs to be defined by the combination of the nature of long-term investors as well as the nature of the actual investment. For example, equity investments, which play a major role in funding businesses, can be long-term or short-term. For these investments it is the nature and behaviour of the investor that make them long-term.

For markets to function effectively, to provide stability and to allow companies and governments to plan for the long-term, it is important that, in addition to investors with short-term trading horizons, there are long-term investors willing and able to buy and hold assets based on long-term prospects.

It is also important to recognise that long-term investment is not only about infrastructure, but also covers a range of other assets including, potentially, sovereign bonds, corporate bonds, equity, venture capital, property, covered bonds and securitisations. A stable regulatory framework, an appropriate supply of funding and investors with long horizons are needed for all these assets to enable long-term planning which is part of capital investment, whether in the private or public sector. In addition, it should be noted that significant infrastructure investments are also made by corporates, such as, for example, utility companies (where investments in infrastructure would be funded through raising of debt or equity). It is important that the understandable focus on ensuring that regulation (such as Solvency II) does not unnecessarily penalise direct infrastructure investment should not result in concerns about inappropriate calibration of other investments being left unaddressed (e.g. relating to corporate bonds, securitisations, covered bonds, property, etc.).

Furthermore, while we understand that the focus of the debate is naturally on long-term productive investments, it is not clear to us how a distinction between "productive" and "financial" capital could be made either in theory or in practice. In addition, we consider that the statements in the Green Paper referring to households which "generally prefer liquidity and easy redemption" and to the fact that "stability is preferred

[1] http://www.insuranceeurope.eu/uploads/Modules/Publications/funding-the-future.pdf

and risk-aversion is now widespread" are only a temporary consequence of the financial context of recent years and not necessarily a defining behaviour of households in general. Empirically, households are often ready to forego liquidity for long-term riskier assets which provide income and capital appreciation in the long-run.

2. ***Do you have a view on the most appropriate definition of long-term financing?***

We broadly agree with the approach to defining long-term investment and investors provided in the Commission staff working paper. We have used the following similar definitions in our report "Funding the future":

- *Long-term investment* is the provision of long-dated funds that pay for capital-intensive activities that have a multiyear development and payback period. Such long-dated funds could be provided in various forms, including a very wide range of assets and asset classes. For example, they can include liquid assets with defined maturity dates (such as corporate bonds), liquid assets without a specific maturity date (such as listed equities), as well as highly illiquid assets (such as infrastructure or private equity investments).
- *Long-term investors* are investors that have the ability, the willingness and the patience to hold assets for a long period of time or until maturity. They are also able to withstand short-term volatility and continue to hold the asset through periods of low value when their analysis indicates such periods are temporary. Long-term investors whose asset profiles are meant to match their liability profiles are generally not faced with forced sales of assets, although they may still decide to sell assets for other reasons, such as to match changes in their liability profile or where their analysis indicates long-term performance is likely to deviate substantially from initial expectations.

3. ***Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of finance to long-term investments***

The role of banks is different from, as well as complementary to the role of insurers. Banks have a long-standing role and experience in intermediation, which is useful and should be conserved. Banks will maintain a key role in channelling finance to long-term investments. However, as banks (re)build capital post crisis and adjust to new liquidity constraints, their ability to fund long-term investment is likely to diminish. Directly or indirectly, insurers could play an increasing role in filling this emerging funding gap.

Insurers already help fund banks' provision of long-term financing in various ways - through securitisations, covered bonds, co-funding and through their funding of bank debt and equity. It is therefore important that the framework conditions ensure that insurers are in a position to continue and potentially develop this role. In addition, where insurers increase direct financing of long-term projects, banks could become important partners by taking on parts of the credit process such as origination, structuring, intermediary services, administration or liquidation.

However, in order to avoid unintended cross-sectoral dependencies, we suggest that the Commission considers a dedicated impact assessment of the overall framework conditions in the banking and insurance area.

4. ***How could the role of national and multinational development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?***

Any public intervention must be balanced against market mechanisms in a way that does not distort the functioning of the markets. Generally, financing of long-term investments should remain at the level of private counterparties within existing credit markets in order to ensure an effective and efficient allocation of resources. This way a level-playing field is maintained and new credit bubbles cannot be generated as a result of a distortion of the pricing mechanisms. Where appropriate, public initiatives could provide opportunities for private sector participation in long-term investment projects such as infrastructure and other relevant projects via, for instance, public-private partnerships or initiatives such as the EIB project bonds. Any such structures should at the same time be supported by a transparent and sound monitoring, accountability and regulatory framework.

Development banks, with their key expertise and specific public objectives, can channel and catalyse private capital to kick-start funding and create liquidity for specific projects which would have significant and clear difficulties gathering finance via the capital markets directly. Such instruments and initiatives can support asset/liability management by institutional investors and can complement insurers' long-term investment portfolios. Governments may consider providing risk mitigation to long-term investment projects where it would result in a more appropriate allocation of risks. Such risk mitigation mechanisms may include credit and risk guarantees, first-loss provisions, public subsidies and the provision of bridge financing via direct loans.

However, public intervention in long-term investment projects should be optimised by identifying any market failures, carrying out appropriate cost-benefit analyses of such interventions and ensuring that any public support is appropriately priced and subject to fiscal considerations.

In this respect, Insurance Europe welcomed the Europe 2020 Project Bonds Initiative, which would enable small and medium-sized insurers in particular to invest in infrastructure assets with good maturity, performance and risk profiles. Similar projects are welcomed by the European insurance industry. However, every effort should be made to ensure that regulatory conditions do not disincentivise the investments in such assets.

5. ***Are there other public policy tools and frameworks that can support the financing of long-term investment?***

A favourable business and investment environment stemming from an appropriate regulatory framework and the effective observance of the rule of law are essential for long-term investment. Policymakers should create transparent, fair and reliable business regulation, supervision and administrative procedures.

In order to limit uncertainty and to safeguard a stable environment for long-term investments, policymakers should take into account the impact of possible changes to the regulatory frameworks on both past and future investment decisions. This implies that changes to regulatory regimes should have no retroactive effects on the existing investment portfolios of investors. This does not mean that regulatory frameworks should always have to be frozen in their current state for existing *and* future investments. Governments must be able to readjust their policy and maintain flexibility in order to take account of changing technological, social or environmental conditions. It is, however, vital to distinguish between the frameworks for future projects for which capital has not yet been committed, and the ones for existing investments, not least by considering the impact of changes to the existing investments. At this point in time, we believe it is crucial for the member states of the EU and EEA to reinforce investors' trust and confidence in the financial system. If successful, this could represent a not easily imitable competitive advantage for the region, helping it to embark on a relatively higher growth path.

Ongoing regulatory reforms and changes should be continuously monitored and reassessed in order to address and limit any adverse impact on long-term investments. Impact assessments should be carried out before the

formal proposals are presented. Impact assessments should consider both the individual effect, as well as the cumulative impact of regulatory changes and developments.

6. *To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?*

Insurers have traditionally played a significant role in funding the European economy.

Insurers' liability profiles enable them to take a long-term investment view, which can be achieved through a wide range of instruments, including equity investment, venture capital, property and securitisations, on top of more obvious forms such as loans, mortgages, covered, corporate, sovereign and infrastructure bonds. The exact mix of assets and their risk-return profiles is highly dependent on the type of products/liabilities that insurers write, which often differ from company to company and/or from country to country.

At the end of 2011, European insurers held:

- 21% of European corporate bonds
- 18% of European equity
- 25% of European government debt
- 11% of euro area bank debt
- At least €400bn supporting other long-term investments via: covered bonds (mortgages), infrastructure, private equity, securitisations, loans

At the same time, a number of regulatory proposals can have an impact on insurers' investment decisions and have the potential to "encourage" sub-optimal allocations to specific assets and/or asset classes.

Developing complementary pension systems throughout the EU would also contribute to enhancing the availability of long-term funding, given that pension products are (by definition) of a long-term nature and predictable, and therefore require long-term assets. To date, complementary schemes remain under-developed in many EU member states, despite the benefits of having mutually reinforcing pillars for pensions. Specifically, a multi-pillar system has the advantage of diversifying risks, since the factors that affect labour variables, and hence the first pensions pillar ("pay as you go"), are not perfectly correlated with factors that affect financial variables, ie variables which determine the performance of second and third pillar retirement systems. Developing complementary pension schemes throughout the EU was outlined as one important objective in the Commission's White Paper on pensions, which Insurance Europe welcomes.

Going forward, safeguarded by a proper framework where challenges and disincentives are addressed, pure market mechanisms will define the "natural" landscape of long-term financing.

7. *How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?*

Good regulation is important for a healthy industry and the move to modern, risk-based regulation is strongly supported by European insurers.

Insurance Europe believes that there is a need for a proportionate prudential regulatory framework which takes account of the risks faced by providers of occupational and personal pension schemes, but which also facilitates (or, at least, does not hurt) investment in instruments which support long-term financing of the EU economy. Ensuring a level playing field between the different providers of long-term pension products on the basis of the "same risks, same rules" principle, irrespective of the type of provider, is also an important

objective. Such an approach would contribute to guaranteeing a similar level of protection to all beneficiaries and members of pension schemes, irrespective of the type of provider.

Insurers' ability to invest in long-term assets is derived from their business model of providing policyholders with long-term savings and insurance products. In order to ensure that long-term assets remain part of insurers' investment strategies, the prudential framework must reflect the risks faced by insurers offering these products to the policyholder and not force them to hold disproportionate levels of capital.

Among the remaining issues to address in Solvency II, many stakeholders have voiced the importance of ensuring appropriate treatment of the long-term nature of the products that insurers offer. The Solvency II framework as currently envisaged may create disincentives for long-term investing from a range of perspectives[2]:

- Correct measurement of risk

It is vital for the Solvency II framework to adopt a correct measurement of risks to which insurers are exposed. More precisely, where insurers buy long-term assets in order to cover long-term and illiquid liabilities, they have the ability to hold these assets long-term or until maturity and are economically not exposed to interim price changes. As highlighted in the Commission staff working document, "investors engaged in long-term financing are generally expected to hold onto the assets for a long time and are less concerned about interim changes in asset prices, focused instead on long-term income growth and/or capital appreciation".

However, the currently envisaged Solvency II rules fail to recognise this ability and induce excessive and irrelevant (or artificial) volatility on insurers' balance-sheets, which is very expensive for insurers to cope with. In addition, the longer the investment the higher the volatility, so the greater the disincentive to invest.

Without appropriate measures, balance-sheet volatility will be artificially high, resulting in more expensive products or fewer resources to provide income to pensioners. In addition to this being bad for policyholders, it would be bad for the wider economy as the long-term nature of the business is what enables the significant role that insurers play in funding long-term economic growth, while also acting as a stabiliser during periods of market stress.

- Appropriate capital charges which do not over-state risks and over-penalise investments

The Solvency II capital regime sets capital requirements for each asset class based on hypothetical shocks to their economic value. This encourages insurers to invest only in assets that are still attractive when capital requirements are accounted for. From this perspective, the currently envisaged capital requirements for a wide range of long-term products in which insurers invest (such as public equity, real estate, private equity, infrastructure) are highly punitive.

The consequences of miscalibrations go far beyond reducing investment in long-term instruments, such as longer-dated corporate bonds or infrastructure bonds. In addition to the direct impact on long-term investments and the potential impact on growth in Europe, miscalibration restricts the investment choices for insurers which can result in lower long-term returns for policyholders and less diversification. Moreover, capital requirements should be able to capture the distinctive characteristics of various investments, such as infrastructure, which carry lower default and higher recovery rates compared to other investments in corporates and prudential rules should be able to appropriately reflect that.

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[2] Addition details and insight regarding the challenges posed by Solvency II are highlighted in the report on "Funding the future: Insurers role as institutional investors"

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Insurance Europe welcomed the European Commission letter to EIOPA of September 2012 requesting EIOPA to examine whether current economic conditions require that the regulatory capital for insurers' long-term investments under the envisaged Solvency II regime be reduced (without jeopardising the prudential nature of the regime)[3].

EIOPA's preliminary response unfortunately focused on a very limited range of assets and failed to investigate the link between appropriate design and calibration of SCR and the ongoing discussions about how best to recognise the long-term nature of the business in balance-sheet valuation. However, we understand that EIOPA is currently addressing some of these points in parallel and we look forward to further discussions.

- Avoidance of barriers which limit the channelling of investments towards SMEs

Any proposal that requires insurers to hold only bonds above a certain credit rating limits the funding provided to entities with a credit rating close to the threshold. Such credit quality restrictions will basically reduce access to funding for all but the largest companies, as SMEs are generally not eligible for high credit ratings (due to a range of constraints, such as their size). Furthermore, credit quality restrictions may result in cliff-edge effects.

If the long-term nature of the insurance business model is not properly dealt with, then insurance companies risk being forced away from long-term guarantees products which will implicitly affect their long-term investments or will mean lower pension pay-outs.

The concerns affecting the provision of long-term products apply equally to pension funds and insurance companies. Insurance Europe is convinced that once an appropriate solution is found under the Solvency II framework, a similar approach could be followed in the review of the IORP, provided the specific characteristics of IORPs are taken into account. This would avoid regulatory arbitrage between the different providers of pension products and will ensure equal protection for members and beneficiaries irrespective of the provider.

In addition, similar prudential rules should apply to both pension funds and insurers when providing similar pension products. Insurance Europe does not agree with the claims that any revision or strengthening of the capital requirements would create a disincentive to the provision of occupational pension schemes by IORPs. Such unfounded claims do not justify not developing new risk-based capital requirements for pension funds.

European insurers are also faced with increasing regulatory requirements with regards to stress tests, which are widely employed in insurers' risk management practice and also represent an important tool for supervisors when assessing the sensitivity of investment portfolios with respect to external shocks on capital markets. While we recognise that stress tests are a useful risk management as well as a supervisory tool, we also consider that an exaggeration of risk scenarios must be avoided, as it can potentially mislead policyholders, investors and supervisors in their interpretation of the risk-bearing abilities of insurers, with potentially negative consequences for the financial stability of insurers and the market as a whole. Exaggeration of risk scenarios (especially in relation to long-term risk-taking) can potentially create a short-term investment bias.

8. ***What are the barriers to create pooled investment vehicles? Could platforms be developed at the EU level?***

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[3] http://ec.europa.eu/internal_market/insurance/docs/solvency/20120926-letter-faull_en.pdf. In April 2013 EIOPA published its initial position regarding the concerns highlighted by the European Commission ("Discussion Paper on Standard Formula Design and Calibration for Certain Long-Term Investments")

The availability of assets is crucial to the significant investment role that insurers play in the economy. Insurers need access to a wide range of assets that enable them to match their liability needs and that allow for portfolio diversification. Therefore, the long-term investment funds (LTIF) initiative is greatly welcomed by the insurance industry as an instrument which could provide access to a broad range of assets pooled together in an investment vehicle. However, when defining and designing such instruments, policy makers should make every effort to assess any potential challenges that could prevent insurers (and other investors) from investing. Such challenges could arise in a range of areas such as: prudential rules limiting or disincentivising long-term investments, taxation rules, national legislation and restrictions, etc.

9. What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?

The capacity of insurers to channel long-term finance can be enhanced by encouraging the flow of premiums which will generate the funds to be invested. More importantly, policy developments should make sure that funding needed to finance the economy is not wasted through, for example, unnecessarily high capital requirements. At the same time, the tax environment and policies should not create any impediment to long-term investment.

While we consider that all efforts should be made to address any weakness and barriers embedded in already existing frameworks and investment vehicles, as mentioned above we also believe that a long-term investment fund vehicle could potentially facilitate the raising of capital. Any such framework should allow a wide range of long-term assets and investments, able to provide long-term investors with portfolio diversification, as well as appropriate and attractive risk/return profile. As previously stated, Insurance Europe welcomes the project bonds initiative.

10. Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be addressed?

Insurance Europe strongly believes that the impact of specific regulatory initiatives should not be assessed on an isolated basis, but rather cumulative impact studies within and across the financial sectors should be conducted.

The OTC derivatives reform (ie EMIR) is an important example of a concern highlighted by the Green Paper, that is: "the simultaneous introduction of liquidity requirements for different financial market players" which "may discourage investments in less liquid assets and hence block several possible financing channels for long-term investment at the same time". More precisely, the rules emerging from the OTC derivatives reform seem to indicate that insurers will need to hold significant amounts of cash to cover derivative collateral needs. Insurers will therefore have to either: 1) hold suboptimal amounts of cash; 2) monetise assets in order to get cash; 3) perform forced sale of assets when cash is needed. Especially in the case of insurers writing traditional life business, with long-term illiquid liabilities, the exposure to cash is limited. While the continual flow of premiums and the low liquidity needs have traditionally enabled insurers to play a counter-cyclical role in periods of market downturn, the new OTC derivative rules risk threatening this role. In addition, regulatory developments in other fields (such as the new rules on UCITS funds[4], the financial transaction tax or the ongoing discussions in the FSB work on shadow banking) risk further amplifying the concerns by limiting the ability to monetise assets for covering collateral needs.

[4] http://www.esma.europa.eu/system/files/2013-314.pdf

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As described in our answer to Question 7 above, there are a range of concerns around the Solvency II framework which, if left unaddressed, can significantly impact insurers' investment behaviour and asset allocation, especially in relation to long-term assets. In that sense, appropriate and optional transitional provisions should be specified in order to ensure protection of the existing insurance contracts.

In future, the combined effects of different regulatory initiatives under way need to be analysed in order to ensure more joined up thinking.

11. How could capital market financing of long-term investment be improved in Europe?

Policymakers should not only promote the development of long-term savings, but also create an environment that ensures trust and stability for those willing to invest in long-term products. They should also promote an effective framework for fair competition and corporate governance.

In addition, policymakers should ensure appropriate protection of investors' rights and not just shareholders' rights.

12. How can capital market help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically, socially and environmentally sustainable growth and ensuring adequate protection for investor and consumers?

Capital markets complement the traditional and central role of banks as credit intermediaries and lending entities. Without deep capital markets, long-term investment in many EU countries relies on a narrow set of financial instruments and particularly banks, which are capital constrained. Taking steps to expand and encourage the range of capital market instruments across all European countries is therefore vital.

A good example of why it is important that financial intermediation evolves would be the case of infrastructure. In Europe, banks have traditionally played a major role in funding infrastructure, particularly in the riskier construction phases. There is, however, a significant reduction in the capacity of the banking sector to fund such large projects. Since infrastructure represents a major opportunity for the European economy given the numerous existing proposals for new transport, energy and communications networks, it is important to revitalise capital markets and improve their capacity to lend to the real economy in the new funding environment.

In addition, Insurance Europe concurs with the assessment that "government policies and regulations need to be as neutral as possible, with respect to private agents' choices between equity and debt financing".

13. What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose the framework?

Investments in covered bonds vary significantly across Europe. There are a range of reasons for this; for example, in some jurisdictions this can be due to:

- lack of an appropriate legal framework for such investments or
- local investment rules restricting insurers' investments in such assets

Therefore, in order to support investments in covered bonds, initiatives which ensure that frameworks for covered bonds exist across all markets could increase the availability of such assets to interested investors.

Extending the range of eligible assets to cover the bonds could also be useful for increasing the availability of funds for the financing of infrastructure, for example.

In principle, the harmonisation of frameworks across Europe could potentially make it easier for institutional investors to diversify portfolios by investing in various covered bond markets. However, given the significant differences that exist across regimes in Europe, the exact implementation of a harmonised regime would be very difficult to achieve. In addition, care should be taken to make sure that any regulatory changes in the covered bonds area do not create any deterioration of already established high standards in core covered bond markets. The disadvantages of potentially lower overall covered bond standards would outweigh the advantages of a harmonised framework.

14. How could the securitization market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?

Securitisation has acquired a bad reputation and new issuance has declined dramatically after securitisation was blamed, at least in part, for the credit crisis. This reputation is largely unjustified in the case of securitisation conducted in Europe. For example, a Fitch Ratings report (April 2012), showed that total losses for products in Fitch's ratings portfolio at end-July 2007 were 6.5% for their triple-A-rated US residential mortgage-backed securities, but only 0.8% for triple-A European, Middle Eastern and African securities.

While insurers are currently invested in a range of securitisations, the most common types are ABS and MBS. Insurers tend to invest in the least risky tranches of these pools of assets, which have the potential for additional returns without significantly increasing the riskiness of their portfolio.

Some market commentators are optimistic that the securitisation market will start to grow again. For example, the Prime Collateralised Securities (PCS) labelling scheme may help grow the market by promoting quality, transparency, simplicity and standardisation of securitisations. It is essential that European policymakers encourage the securitisation market. For example and to this end, it would be helpful if private initiatives such as the PCS label would be considered as a criteria for risk assessment and implicitly taken into account in a risk-based capital charge framework as soon as they prove effective outcomes.

We would like to highlight the fact that Solvency II represents a significant barrier to investing in securitisations and this is mainly due to what Insurance Europe regards as unnecessarily high capital requirements. For example, based on the Standard Formula, the capital required for a triple-A ABS with 6-year duration is 42%.

15. What are the merits of various models for a specific savings account available within the EU level? Could an EU model be designed?

We are generally cautious about the introduction of new savings vehicles, which would enhance complexity and could encourage short-term investment behaviours. Such an involvment in the allocation of capital should only be considered in cases of demonstrated market failure. The first priority of governments should be to address funding challenges by improving already existing channels and mechanisms, such as:

- Ensuring that banks continue to be in a position to do financial intermediation and to channel investment, with the support of capital markets / institutional investors
- Increase the flow of savings from individuals, which can be achieved through:
    - Education (increased awareness among the population of saving for old age and the promotion of financial literacy)
    - Financial inclusion policies

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- Encouraging and incentivising 2nd and 3rd pillar pensions (ie by appropriate tax incentives, collective agreements, automatic enrollment)

Specific savings accounts are intended to serve special savings objectives of the population such as retirement income or individual home ownership. Regulatory frameworks across the EU ensure that those individual objectives may be achieved by a diversity of product providers and that they do not require specific investment strategy choices by individuals. The design of the products should reflect the traditions of the EU member states and the preferences of retail investors. An artificial EU-wide model product should be avoided as it would impede product innovation, limit diversity and undermine competition.

16. What types of CIT reforms could improve investment conditions by removing distortions between debt and equity?

Insurance Europe would like to highlight that debt and equity can be both long and short-term investments. Generally, Insurance Europe believes that tax neutrality towards different forms of financing should be promoted or, at least, tax rules should not act in a way that influences investors' choice of debt or equity.

17. What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term savings in a balanced way?

Taxation laws can encourage individuals and investors to adopt a long-term investment philosophy. Specifically, tax incentives encourage individuals to plan for retirement, locking their savings in for the long-term. For the economy, such an approach results in a flow of premiums, that insurers can invest in assets with a long-term perspective, thus helping to fund economic growth.

Insurance Europe is concerned that despite the importance of ensuring a flow of funds with a long-term perspective, and the important role appropriate tax incentives play in achieving this objective, many European governments are responding to their fiscal problems by removing these tax incentives. This short-term approach could not only restrict the availability of long-term funding for Europe's businesses, but also worsen governments' fiscal situation as it will reduce economic growth and, hence, the tax base. In addition, such an approach reduces the ability of citizens to save for their old age.

18. Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities?

As there is a significant risk of misallocation of capital, any tax incentives for certain long-term investments products have to be carefully considered.

19. Would deeper tax coordination in the EU support the financing of long-term investments?

One of the most important preconditions for long-term investments is to have a stable and reliable tax framework, but also one that does not act against long-term investment. Insurance Europe is concerned that the recent European Commission proposal on an FTT could have such a consequence that is could adversely impact long-term investments.

- In particular, Insurance Europe is concerned by the very wide scope of application proposed, ie most markets, financial instruments and financial actors. This means that transactions conducted when

pursuing a long-term strategy would be as directly affected as transactions with a speculative purpose. This contradicts the Commission's objective of reducing speculation in the markets.

- In addition, a series of features of the FTT proposal would increase companies' cost of funding. For instance, the proposal to impose a tax on all transactions on bonds in the secondary markets would significantly reduce the liquidity in such markets, and as a result make it more difficult and expensive for companies and governments alike to raise money.
- Imposing the FTT to transactions in the repo/securities lending market has the potential to threat the ability of insurers to monetise their long-term assets (backing long-term liabilities) for covering short-term liquidity/cash needs. As highlighted in our response to Question 10, any limitation in insurers' ability to monetise assets will force insurers to hold sub-optimal amounts of short-term and highly liquid assets (such as cash), to the detriment of long-term ones.
- Insurance Europe is also concerned by the fact that the Commission proposal would result in significantly lower returns on the investment made by individuals in view of their pension, be it through occupational or personal pension products. Consequently, we believe that the flow of funds invested by individuals in such products would go down, which in turn would reduce the long-term funding opportunities of corporates and governments.

For these main reasons, Insurance Europe opposes the introduction of the financial transaction tax as defined by the Commission[5].

20. To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

Insurers' business models are such that the liability' profile is the main driver of insurers' investment behaviour. Insurance liabilities are to a large extent long-term and predictable, with stable cash flow profiles. Therefore, insurers are substantially able to match long-term liability profiles with investments held long-term. Because most insurance policies create predictable and long-term liabilities for insurers, they can invest in long-term and illiquid assets.

Asset/liability management (ALM) for insurers means that insurers manage assets according to the liability profile in order to meet obligations to policyholders. Because of the variety in insurance products, an insurer can have different business models and thus follow different ALM strategies. This implies that insurers should be able to apply different measurement and presentation provisions depending on the characteristics of their insurance portfolio.

Insurers typically tend to hold their investments (such as debt or equity instruments) long-term or until maturity (in the case of bonds). The selling and buying activities which insurers have to undertake have the main common objective of rebalancing the portfolio of assets backing insurance liabilities on a regular basis to ensure that the contractual cash flows from the financial assets are sufficient to settle the insurance liabilities. However, it is important to note that, in contrast to some other businesses, insurers should not be considered as traders. As insurers have low liquidity risks, their investment strategies usually stabilise the financial system.

Insurance Europe believes that the importance of accounting should not be underestimated and it creates an important source of information for investors. The necessity of appropriate reporting requirements has been acknowledged by the International Accounting Standards Board (IASB), in charge of setting the International Financial Reporting Standards (IFRS) principles. As such, the Board decided to introduce a mixed

[5] For additional details, please see Insurance Europe position paper regarding the introduction of the financial transaction tax

measurement model in IFRS 9 (i.e. full fair value, amortised cost, fair value through other comprehensive income). We support this decision, which recognises the diversity of business models and reflects users'/investors' needs.

In addition, insurers acknowledge that current measurement of assets and insurance liabilities may present useful information to investors and shareholders. Presenting a balance-sheet based on current values is in fact a cornerstone of IFRS 4 "insurance contracts", as is the inclusion of most financial assets categories at fair value under IFRS 9. However, fine-tuning is needed to allow for a transparent and proper reflection of the long-term nature of the different insurance business models. As ALM is the fundamental core of an insurer's business, the challenge is to find appropriate solutions able to recognise the interaction between all assets (especially debt instruments offering stable cash flows able to match liability' cash flows) and the related insurance liabilities. In the context of the requirement of the IASB to measure insurance liabilities at current value, the current measurement of assets reflects a consistent measurement on both sides of the balance-sheet. However, it does not solve the critical issue of appropriately reflecting the presentation of current value changes in performance reporting given the nature of the various insurance business models. For insurers, the appropriate presentation of the performance in the profit and loss is critical in order to make the insurers' financial position and performance comprehensible to investors. This should reduce insurers' cost of capital and so facilitate their support of long-term investment in Europe.

As mentioned earlier, insurance companies are predominantly long-term investors and therefore it is important to reflect meaningful performance in their earnings. Depending on the nature of the insurance products/liabilities and the related assets, there is a clear need for different classification possibilities including "amortised cost", "fair value through other comprehensive income" and "fair value through profit and loss".

21. What kind of incentives could help promote better long-term shareholder engagement?

Insurance Europe believes that as long as framework conditions are not biased against long-term investments, creating unnecessary and inappropriate disincentives, there is no specific need for or benefit from creating additional incentives. Furthermore, incentives to promote shareholders' engagement would often be difficult and challenging to implement in practice. Insurers strongly believe that long-term commitment in investment strategies is key in delivering performance and beneficial to investors and the economy as a whole. Therefore, a self-commitment to exercise voting rights is preferable. In addition, the possibility of exercising voting rights in a cross-border context should be improved.

22. How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?

Investment mandates and incentives should be aligned with the owner's (e.g. the policyholders') investment objectives (eg investment horizon, risk aversion, targeted sensitivity of assets portfolio, etc.) and should not artificially bias indications towards long or short-term investment horizons.

The best way to encourage long-term investment is, as indicated in other responses, to:

a) Seek ways to encourage owners to be willing to invest long-term
b) Ensure there are no unnecessary framework biases against long-term investment

Best practice guidelines helping smaller insurance companies and other investors with long-term horizons to design investment mandates and incentive schemes which ensure asset managers are aligned with their objectives could be of help. For example, appropriate use of contractual elements such as claw-back provisions, high watermarks or long-term performance measures can be used by asset owners when defining asset managers' investment mandates.

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In the insurance sector, there are extensive regulatory requirements placed on investments which cover the relationship between investors and asset managers. These requirements ensure the interests of investors and asset managers are aligned. Therefore, Insurance Europe considers that further regulatory measures are not needed in the area of monitoring and regulating asset managers.

23. Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?

No.

Fiduciary duty is currently defined across European jurisdictions in different ways, but with common elements regarding trust, confidence and good faith. The definition of fiduciary duty should not deviate from the objective of aligning the interests of financial managers and customers by introducing a specific focus on short-term vs. long-term fiduciary duty.

25. Is there a need to develop specific long-term benchmarks?

No.

However, we note that guaranteed products automatically create a long-term benchmark as, once a payoff promise has been made, the investment objective becomes outperformance against a guarantee rather than outperformance against current market performance. This has the benefits of allowing/requiring insurers to take a long-term view in their investment approach.

30. In addition to the analysis and potential measures set out in the Green Paper, what else could contribute to the long-term financing of the European economy?

Regulatory consistency and stability across the member states would foster an environment in which those with capital would be more inclined to invest. Member states should thus not only promote long-term investments but also create an environment that ensures trust and stability for those willing to invest in long-term financial commitments.

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe’s economic growth and development. European insurers generate premium income of more than €1 100bn, employ almost one million people and invest around €8 500bn in the economy.

Long Term Investors' Club (LTIC)

19.06.2013

Contribution of the European members of the LTIC to the EC's Green paper on long-term financing of the European economy

In the last four years the European members of the Long Term Investors Club[1] have been campaigning, alongside other economic and financial associations, to raise the attention of the EU and of the global community on the key role of long-term investment (LTI) for a balanced, inclusive and sustainable growth.

At the global level, the Russian Presidency of the G20 proposed that the issue of LTI financing be given priority status on the Agenda for 2013. This could mark a turning point. At the first G20 summit (Washington D.C., 2008), during the discussion on the guidelines for reforming the financial system, the issue of LTI was not even considered. It is true that the conclusions of the G20 summit in Pittsburgh made the objective of growth (strong, balanced and sustainable) a central priority. But in reality, this did not alter the bank-oriented, short-termist, pro-cyclical approach that dominates the international regulatory culture. Rules and measures aimed solely at ensuring financial stability have helped transform the crisis into a double-dip recession, thereby thwarting, at least in a good portion of Europe, efforts to restore financial health and achieve fiscal consolidation.

The persistence of the crisis obliges all of us to acknowledge that, in a modern market economy, financial stability, growth and social cohesion are inextricably intertwined, and that investment is a key factor not just for growth and competitiveness, but also for the stability of financial institutions and for rebalancing the public finances.

The European members of the Long Term Investors Club therefore warmly welcome the publication of the Green paper on "long term financing of the European economy" published by the EU Commission.

This Green Paper is an important step in the reorientation of the model of growth in the European Union. It properly identifies rules, conditions, instruments and incentives that could foster the flow of private capital into LTIs, following the guidelines identified, some years ago, by the Jacques de Larosière and the Mario Monti Reports.

Many constraints, largely due to the financial crisis and the strengthening of financial regulation have affected the capacity of the European economy to finance these investments. It is therefore a major challenge for the EU to set up the right framework to foster the channelling of appropriate resources to the financing of LTIs also for the ultimate benefit of future generations. In this context, the Green Paper explores many interesting proposals to promote the long-term financing of the European economy.

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[1] *www.ltic.org – The European Members of the LTIC are : APG, BGK, CDC, CDP, EIB, ICO and KfW.*

1) *Do you agree with the analysis out above regarding the supply and characteristics of long-term financing?*

The Commission made a good analysis of LTIs needs but we still are missing a more detailed economic study that could underpin the contribution of LTIs to sustainable growth. There is no such study at present partly because there is no mechanism for tracking this aggregate within the macroeconomic and financial datasets. To this end, a stricter cooperation with the OECD may be necessary.

2) *Do you have a view on the most appropriate definition of long-term financing?*

As a preliminary remark, we would like to stress that the priority should be given to Long Term Investment itself – before defining it's financing. Priority should be given to **the identification of high quality projects**, economically (and not only financially) viable, that have positive externalities on competitiveness and, more generally, on society as a whole.

Regarding the characteristics of long-term investment described in the Green Paper we consider that the definition could be slightly amended. In our view, "long-term financing" should be considered as **the policy and/or liability driven intention and financial capability to hold assets financing long return real investments.**

Long-term financing could therefore be considered as ***the process of investing or lending implemented by a specific type of investor who (i) can count on sufficiently stable (especially long-dated) liabilities, and (ii) has the expectation of holding an asset for a long period of time with the purpose of achieving a fair, risk-weighted return.***

Indeed, stable liabilities – whatever they are (public resources in the case of SWF, public resources and/or private savings in the case of long-term financial institutions, private savings in the case of insurers or retirement funds) – are the prerequisite of LTI and account for the characteristics of the LT investor.

Furthermore, the category **"long-term investors**" is heterogeneous and does not just include institutional investors (defined as insurers and pension funds) or national and multilateral development banks (such as EIB, KfW, ICO or BGK), it also covers long term public financial institutions (like French CDC or Italian CDP).

Policy makers and regulators should indeed encourage and safeguard the diversity of those institutions that can act as long term investors. As far as this kind of investors can attract stable, longer-dated resources (above all, trustful private savings[2]), their diversity per se is self-stabilizing the financial market ecosystem and is a guarantee of stability that may prevent the emergence of bubbles that dangerously affect long-term economic growth.

In this respect, it is important that the EU adopts a clear definition of long term investors, compatible with the principles being defined at OECD level in the framework of the High Level Principles on Long Term Investment that will be submitted to the G 20.

3) *Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?*

The European banking system has substantially slowed down medium and long term lending. Before the crisis, the European banking system financed over 90% of the debt

[2] Directly or through capital markets

component of Project Finance. Pension funds and insurance companies backed around 40% of medium and long-term bank lending for infrastructure, by acquiring bank bonds and securitised loans for these projects in their portfolios. Monoline insurance companies guaranteed risk related to any (temporary) instability in the cash flows generated by the works being financed.

With the crisis, this model has stopped working. Monoline insurance companies have all but disappeared; the new regulations act as a disincentive for life insurance and pension funds to invest in infrastructure assets. The European banks, which already have to cope with the crisis and the new more stringent ratios, face higher funding costs, and have lost confidence in each other, thus making it difficult to syndicate loans, especially medium and long-term exposures. Together with the decline in public investment budgets and the increase in lending costs, this has blocked many infrastructure investments.

There has been a similar adverse impact on financing for corporate investment, which is crucial for competitiveness and growth (such as investments in R&D, innovation, technology and human capital). The capital requirements under the new regulatory framework took into account the adjusted risk weights for SME but still affect bank lending to SMEs especially hard. The most recent ECB data show that, over the last year, around 20% of SMEs have seen the terms of their access to credit deteriorate, while only 4% of large companies have been hit by the credit crunch. Only major companies continue to be able to access the capital markets directly by issuing corporate bonds.

The European banking crisis has therefore had serious repercussions on banks' ability to finance LTI.

It is difficult to affirm that we are witnessing a change in the European model of financing investment, with institutional investors partially replacing banks or with companies directly accessing the capital markets. But in any case, a structural change of this magnitude, which would push Europe closer to the Anglo-Saxon model, has a long way to go. There are too many cultural, regulatory and structural differences between the economic and financial systems on both sides of the Atlantic. More likely, the European system will evolve into a "hybrid model", in which the banking sector will continue to play an important, but not exclusive role in financing the real economy. Policies will therefore need to respect and address the important role of the banking sector. But, long–term investors will also have to fill the gap as regards long-term financing.

4) *How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals?*

The category of **"National and Multilateral Development Banks**" in which LTIC members are classified in the Green Paper does not match with the diversity of our institutions which can be rather defined as "long term financial public institutions" (cf. observation under point 2).

The role of long-term investors has become increasingly important; they have played a major role in satisfying part of the long-term investment needs of the economy, at national /or European level. Our institutions have developed new instruments and mobilized additional resources, notably to support infrastructure financing and SMEs. They have launched new domestic or European long term equity funds to invest in infrastructure (cf. Marguerite Fund) and strengthen company capitalization, etc.

By doing so, they contribute to significantly lower (real and perceived) uncertainties and consequently to mitigate risks and risks' perception of other economic and financial agents, bringing them back to long term finance.

The cooperation between these different institutions has to be encouraged by policy makers and should result in the creation (set-up and management) of new efficient financial instruments. In this respect, the "financial institutions" which are referred to in the proposed regulation of structural funds should be defined more precisely and consistently with the diversity of long term financial institutions.

It is important to stress that these institutions are "complementary" and not in "competition" with other market participants. Since they consider themselves as being more "policy oriented" than "profit oriented" they can afford to support the market, especially in this critical phase for the European financial system, by aiming at more moderate IRRs and longer durations to the financing of investments and by doing this they cover "market failures" without "crowding out" private resources.

More generally **the Commission should further rely on national public financial institutions**; a greater cooperation with these institutions would indeed:

- bring a better understanding of the different national markets and their needs,
- allow a better calibration/integration with existing European programs,
- develop the capacity of deployment of European funds at national level and reinforce their visibility;
- reach a critical mass of funding and a better cost efficiency by mutualizing some resources.

How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?

The Green Paper is taking the right approach in calling for a more substantial allocation of EU budget resources to support EU financial instruments, rather than pro quota direct grants to national Governments. In our view, the advantages are: the multiplier effect of resources across strategic sectors and an important increase of competition towards the best projects.

The Project Bond Initiative is part of this framework. It could serve as a valid alternative for those institutional investors, including international investors, who want to expand their interests in infrastructure assets.

Moreover, we believe that the scope of application of European guarantees for project bonds (today it only covers bonds issued in association with TEN-T, TEN-E and NGN) or bank project finance could be extended to a wider range of investments, such as health care, R&D, public utilities, urban development and energy efficiency. Doing so it has to be ensured, that promoted project bonds do not crowd out existing bank financing instruments in efficient markets.

Regarding the equity side and the debt side: to meet the different promotional structures and market situations in the EU Member States a two-sided approach should be taken into account:

- Develop flexible EU guarantee instruments to increase the range of existing or new promotional loan products;
- Address the critical funding crises affecting the venture and growth capital market across Europe and consider the allocation of EU funds to investment vehicles supplying capital to equity funds.

Furthermore, our institutions could encourage the EU Commission in creating guarantee instruments designed to mitigate risks associated with the long-term nature of LTI, especially with regard to regulatory or other political risks. In order to reduce the latter, consideration should also be given to drafting a specific European directive prohibiting retroactive *reformatio in peius* (“*aggravating change”*) of rules that would significantly affect the profitability of investments, or that impose forms of (at least partial) compensation.

5) *Are there other public policy tools and frameworks that can support the financing of long-term investment?*

Regulation is clearly an issue, as developed throughout our contribution.
As a matter of fact, Solvency II for insurers and a new prudential framework for pension funds could result in a cornerstone for incentivizing LTIs of these extremely important institutional investors.
It is important that prudential regulation and financial market regulation should at least not be counterproductive to long term investment.

6) *To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?*

Subject to these regulatory adjustments, other long-term institutional investors, such as insurance companies and pension funds, can become major investors in infrastructure as an asset class.

Total Global Assets of Long Term Institutional Investors are estimated at USD 87.8 trillion. Investment allocation to infrastructure is about 3% of total investments globally, equivalent to about USD 2.6 trillion. Potentially, Long Term Institutional Investors investment could grow up to about USD 4.5 trillion[3]. The goal is reasonable and the increase of resources for infrastructure quite outstanding in size.

However, more will be needed to increase the appetite of large institutional investors for direct equity commitments. One solution is the sitting together of direct investments by institutional investors and infrastructure funds. For example, when an insurer co-invests in an asset with a fund, the institutional investors are keen to rely on the manager of the fund and do not need additional governance over what they are doing. By being at the top table, the institutional investors are jointly responsible for how the deal is structured. And by making sure their key governance requirements are dealt with, they can also help set the agenda for the consortium as a whole. By taking a meaningful level of control, the direct investor can become much more comfortable with the structure and management.

One reason which is slowing the flow of direct investment into infrastructure is the appetite for risk. Pension and insurance funds cannot threaten their ability to meet obligations in the long run. Any project which contains unquantifiable risks, such as those posed by construction, traffic or regulation, are not feasible for non-aggressive investors such as pension and insurance investors.

In recent years, pension funds have been increasing their participation as direct investors in infrastructure transactions globally. One of the fundamental reasons for the move towards direct investment is the broad recognition that infrastructure investment does not always lend itself to the private equity-type fund model. For the broader pension fund sector, there are typically no formal requirements to exit their investments within 5, 8, or 10 year cycles and

[3] *or 5% of total Asset under Management, according to a recent HSBC's research*

so, if they are going to take long-term views on infrastructure, they can actually make more of their capital structure by investing directly.

Governance risk management by long term institutional investors has therefore to be reinforced to include also infrastructure financing. Building internal capacity is expensive and needs a large dose of innovation in investments' allocation strategies. As institutional investors expand and move into new geographies and sectors – particularly if they are trying to execute multiple transactions or overly complex transactions at the same time – a key challenge is ensuring that they have built up the right team. Both resourcing and filtering the deal flow are challenges.

Institutional investors are facing a cultural change in developing a direct investment program to invest in infrastructure projects. There are well known best practices in countries such as Canada and Australia where pension funds and insurance companies invest up to 15% of their asset in infrastructure projects. Their model, or at least similar ones, should be replicated elsewhere.

Finally, consider risk-segregation in the different phases of projects, i.e. construction, development and managing. Each phase may need special financing actors, rules and instruments, with banks (both private and public) taking care of the first (construction) and the second (development) phase and the capital market, i.e. institutional investors taking over the longer term and lower risk management phase.

7) *How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?*

As the OECD puts it in its draft High-level principles of long-term investment financing by institutional investors, institutional investors with a longer term investment horizon *"should be adequately regulated and supervised, taking into account their specificities and in line with relevant international standards"*.

Current prudential or accounting regulations do not properly take into account the specificities of long term investment. That is why there is a room for a **special framework** applicable to long term financing.

For instance, regarding prudential supervision, the risks of assets should be assessed taking into account the nature and the duration of the liabilities; moreover, the prudential framework should recognize the positive effect of long-term liabilities. Compliance with the solvency constraints should be designed in such a way as not to compel long-term investors to sell assets they would otherwise have the capacity and willingness to hold in the long term.

We consider stability of the financial system as the overarching prudential objective. Against the background of recent crisis experience, financial stability is jeopardised in particular by pro-cyclical and chain effects, often triggered by undue portfolio concentration in loans or financial instruments and exacerbated by a lack of investor diligence. A well conceived set of prudential rules for the insurance sector in a broader sense therefore should help to reduce these flaws and by the same token enable the sector to complement traditional bank lending and capital market financing. Ideally insurers would be incentivized to provide long term funding and by the same token absorb credit risks, which would otherwise remain within the banking sector.

In terms of investments in financial instruments, we recommend avoiding additional regulatory incentives for instruments with a strong credit link (i.e. interdependence of credit

quality), in particular sovereign, bank and covered bonds. While Solvency II rules as they are designed up to now would prevent insurers completely from securitisation investments, a more favourable treatment could help them to diversify their portfolios, provide long term funding and absorb credit risk out of the banking sector. We doubt if it makes sense from a prudential as well as an economic perspective to grant a more favourable regulatory treatment to direct lending by insurers compared to investing in securitisation, collateralised by the same credit risk but with manifold structural credit enhancement features.

8) *What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?*

If institutional investors decide to pool their investments with other institutional investors they may benefit from economies of scale, which may allow for lower trading costs, diversification and professional management. In order to optimize the benefits for institutional investors from using a pooled vehicle in practice certain conditions need to be met, such as adequate knowledge and experience of the manager of the vehicle, good governance and as much as possible pooling funds of similar types of investors with similar risk profiles.

Currently several barriers for pooled investment vehicles exist:

Practical barriers
What could create a barrier is a lack of the relevant knowledge. This particularly goes for long-term financing in the form of debt. In this market, it is mostly the banks that have the appropriate in-depth knowledge and they probably will not be willing to set up and/or manage such new type of pooled investment vehicles. This is the reason why certain other market parties have recently initiated infrastructure debt funds/investment vehicles themselves. The infrastructure debt market requires very specific knowledge which is not all around available, especially not other than within banks that are present on this market for 20 years.

Tax barriers
Tax barriers relate both to (i) local withholding taxes, (ii) local Corporate Income Taxes (CIT) and (iii) the diversification between countries regarding withholding taxes and possibilities and procedures to mitigate those taxes:

(i) Regarding withholding taxes, institutional investors benefit in some investment countries from withholding tax exemptions or lower withholding tax rates as compared to 'normal' companies. It should be clear, in advance, that the withholding tax position of the institutional investor not gets deteriorated by using this (new) type of investment vehicle. This will be the case if such new vehicle can be set up as a tax transparent vehicle[4].
Summarizing the ultimate goal for creating a new type of investment vehicle should be that the withholding tax position of institutional investors which invest via this new vehicle will be the same or better compared with a direct investment of the institutional investors.

(ii) Local Corporate Income Taxes (CIT): In most EU countries, institutional investors typically enjoy a beneficial CIT position in their home country. One practical example is a CIT exemption for domestic pension funds. Where the tax legislation in a (EU) country 'A' provides for such CIT exemption to domestic pension funds, the same exemption is generally granted to foreign pension funds resident in a (EU) country 'B' for income derived from investments in country A, in compliance with EU non-discrimination provisions. Barriers could arise once foreign pension funds do not invest directly in country A, but indirectly through a pooled investment vehicle: the tax legislation of the investment country A may not provide for

[4] Also recognized as such by the tax authorities in jurisdictions from which the investment vehicle received dividends, interests or other payments

a ‘look through’ through the pooled investment vehicle up to the underlying foreign pension funds. This would result in the foreign pension funds being unable to claim their CIT-exemption in country A, to which they would have been entitled to if they had invested directly. Hence, also for purposes of the CIT position of institutional investors which invest indirectly in a foreign country, a new pooling vehicle should in that country be entitled to a ‘look-through’ to the underlying investors.

(iii) Another tax barrier consists of the diversification between countries (including EU Member States) regarding withholding taxes and possibilities and procedures to mitigate those taxes (based on existing double tax treaties). Each country does have its own system and forms and it depends on the legislation of the investment country if an investor can apply for relief at source and/or for reclaim of the taxes withheld. The EU can play a role in harmonizing the procedures and forms. It would be very beneficial for all investors if they can apply for relief at source instead of reclaim in all European countries with similar forms, instead of each country having its own form. See also the TRACE Implementation Package (‘TRACE’), a project of the OECD.

9) *What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?*

Tailor-made fiscal incentives could be designed in order to attract financial resources and savings to LTIs, above all through institutional investors. This should, however, be implemented without jeopardizing the fair competition setting of intermediaries and instruments.

10) *Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?*

Today, the regulatory framework is skewed in favour of short-term lending, including speculative loans, while penalizing LTI, thereby discouraging those investors (particularly pension funds and insurance companies) that, in view of their usual business model, could hold long-term assets. This does not mean diminishing the effectiveness of measures meant to prevent new crises and preserve financial stability, but to fine tune them in order to reduce their recessive effects, adapting the rules to the specific business models of financial institutions other than commercial banks.

The concept contained in the Green Paper for “*an integrated re-calibration of the regulatory framework*” is the right approach for revisiting the current prudential regulation to achieve stability and stronger incentives to invest long term for the institutions in the scope of these regulations. But fine tuning prudential regulations alone is not enough to create a regulatory framework more favourable to LTI. Indeed, regarding accounting regulation, the concept of fair value in IFRS 9 is providing high procyclical short termist incentive in the worst moment of the cycle. Concerning prudential regulation, as stated above, besides fine tuning for existing regulations or regulations in the pipeline, there is room for a specific framework dedicated to long term investors.

At the European and national levels, much still remains to be done to obtain investment friendly regulation and to reduce risks and regulatory costs. Political and legislative stability, fast and streamlined administrative procedures, low regulatory and bureaucratic burdens, a swift and reliable judicial system, and an efficient and technically capable public administration are recognised as key factors in investment decisions, which today consider

the entire globe. In several European countries, the low quality of the political framework, regulation and remaining regulatory risks are still, despite some recent progress, among the greatest barriers to LTI. In the European administrative space, which finally acquired a legal basis with the Treaty of Lisbon, we can now consider a European policy of better regulation, aimed at the convergence of European and national regulations towards investment friendly models.

11) How could capital market financing of long-term investment be improved in Europe?

Based on our experience in the development of new instruments and the mobilization of additional resources, our long term financial public institutions, recommend a better promotion of the innovative financial instruments notably through capital markets.

The Founding members of the LTIC can build on the success of the pan-European equity fund Marguerite launched with the support of the EU Commission and on successful financial instruments implemented with EU and national budgetary funds at Community as well as at national level, to go further and satisfy a significant part of the long-term investment needs of the European economy.

Today, we are ready to play our part in achieving the Europe 2020 Strategy's objectives of smart, sustainable and inclusive growth in acting as catalysts in the framework of the “innovative financial instruments” launched in 2011 by the European Commission. These Innovative financial instruments are clearly designed to leverage budgetary interventions in long term sectors (infrastructure, innovation/ research, sustainable development, SME’s…).

It appears critical that the Green Paper emphasizes these long term financial tools. The commitment of our institutions through these tools would indeed have a triple benefit for the European economy: the attraction of private resources and foreign direct investments, the mitigation of risk for other economic agents in areas of EU strong interest and, consequently, the improvement of the European competitiveness.

In particular, the transformation of the banking/financial sector due to strengthened regulatory requirements (for banks: Basle III/CRR and CRD IV and Solvency II for insurance companies) require that EU Capital Markets play an increasing role in the long term financing needs of the European economy.

In this perspective, long-term investors have the capacity to leverage budget resources e.g. through project bonds that would allow to attract private and foreign resources for the financing of long term investments. It is a critical path to ensure the competitiveness of the European economy by attracting capital from domestic and international investors, filling the gap left by constrained budgets and deleveraging banks.

In this respect, the Green Paper should consider some incentives likely to foster this involvement: *e.g.* to ensure that credit ratings are not limited to a one-year horizon or to consider the creation of a dedicated label for supportive long term investors. It is therefore also crucial to develop new financial instruments to promote long term assets, e.g. in the infrastructure sector as for example Project Bonds that will benefit from a transparent and liquid market.

12) How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?

13) What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?

On the one side a more harmonized framework for covered bonds would make it easier for investors to assess these products and thus would contribute to their development. A legislation at the EU level could increase the transparency of these bonds, not only before their issuance (details about the financed assets), but also once they have been issued (information about their performance).

Against the backdrop of any discussion around an improved covered bond framework, we would like to point to the systemic risk which might result from further increasing the regulatory promotion of covered bonds (i.e. LCR, capital requirements under CRD IV/Basel III.5 and Solvency II, bail in). Just to name a few, the issues of asset encumbrance, pro-cyclicality in terms of issuer and instrument credit quality and investor's behaviour (i.e. thorough analytical approach vs. over-reliance on ratings and safe haven status) should be analysed carefully, in particular with regard to any potential regulatory approved expansion of eligible cover pool assets. Therefore there is a risk that a more harmonised framework leads to lower standards in countries with a highly developed covered bong legislation and to a loss of confidence among investors.

Moreover, securitization of PFI lending should be revived. The recovery rates of infrastructure lending have been recently found to be statistically higher than the recovery rates of corporate bonds (Standard & Poor's, 2012). So infrastructure bonds (via securitization of lending to PFI initiatives) could become quite attractive to institutional investors.

14) How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?

Securitisation can play an important role as link between the credit and the capital market. One should bear in mind that SMEs are not only financed via loans but also to a large extent via leasing contracts. SME securitisations are therefore useful funding instruments for both banks and leasing companies and should be part of a healthy funding mix of the real economy. A huge advantage of securitisation is the matching of maturities on the asset and liability side, which leaves some uncertainties out of the investor's equation.

Regulatory uncertainty and unfavourable regulatory treatment (i.e. Revision of the Securitisation Framework, Liquidity Coverage Ratio) constitute from our point of view the major obstacles on the avenue to revive the EU securitisation market. Its overall regulatory framework should be designed in a way to re-establish a level playing field for securitisation compared to other capital market based financing instruments. Potential investors in securitisation instruments should be in a position to assess the relative value in an unbiased way. This is true for the whole financial sector (banks, insurance companies, asset management firms). A regulatory level playing field has to be seen as the condition sine qua non for a revitalisation of the EU securitisation market.

With a view on financial stability, the regulatory framework should reflect the true economic risks of securitisation in an unbiased way and taking into account empirical evidence in the EU as well as progress which has been made during the last couple of years in terms of transparency (loan level data, European Data Warehouse), labelling (PCS, TSI) and last but not least regulatory induced formalisation of alignment of interest as well as analytical requirements for investors (Article 122a CRD). We believe there is high investor demand for long term finance. However the current regulatory environment (especially the uncertainty

with respect to the forthcoming regulatory regime) creates high investment uncertainty and therefore hinders investments. Therefore we highly recommend creating an environment where investors can get a better certitude of what the regulatory treatment of their investment in the future will be.

A difficult situation is given in Non-core countries, as the rating of SME securitisation are substantial below 'AAA'-Level, which leads to a very punitive capital requirement for any regulated investor. Therefore one option could be "lending" the rating of a better rated institution (e.g. EIF) and therefore guaranteeing the senior part of such a structure.

National and multilateral development banks could play an important role as anchor investors to revive the SME securitisation market. In short this means that these banks could initially take up larger proportions of a transaction to make them economical or take part of the securitisation structure which are not placeable with current investors. Once the market is revived the national and multilateral development banks could slowly withdraw from the market.

15) *What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?*

16) *What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?*

17) *What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?*

18) *Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities?*

Tax incentives were crucial to the success of the US stimulus plan and the related Build American Bonds. If used to encourage project financing and PPPs, then there seems to be a strong argument for them: on the one hand, they enable investments that otherwise would require the use of public resources; on the other, these investments contribute to growth and, therefore, fiscal consolidation.

This is indisputable, at least in cases in which incentives are strictly intended to rebalance financial plans that have been impacted by the elimination of expected public subsidies or the increase in the cost of bank loans. And it is limited to a portion of the higher tax revenues generated by this investment, net of any substitution effects, as recently provided for in the Italian legislation on financing infrastructures through tax relief.

19) *Would deeper tax coordination in the EU support the financing of long-term investment?*

20) *To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?*

We believe that there is a need to review the current regulatory and international accounting framework to take into account long-term investment specificities.

The business model of Long Term Investors (LTIs) is characterised by the provision of finance through lending and equity instruments, usually on a long-term basis, in order to support public policies. LTIs support structural policies (e.g. growth through investment) and also operate on a countercyclical basis. Their activity mix derives from the public policy agenda and not from profit objectives.

IFRS 9 has focused on very short term market value, ignoring the long cycles and notably the cycles related to infrastructure investments.

The accounting standard IFRS 9 provides highly pro-cyclical incentives.

It requires investors to value their assets at market value (fluctuating, by definition) and not the value at maturity of the project. The standard intends to import useless market volatility into the balance sheets of long term investor, discouraging them to hold asset for longer periods. This could just lead to more market instability.

IFRS 9 does not sufficiently take into account the time horizon of investors' assets. Accounting standards should give more importance to the "business model" of financial institutions in the classification and measurement of financial instruments and provide a model for hedge accounting reflecting the economic reality of risk management. Indeed the diversity of business models and of their perception of value through accounting standard is the very core of the dynamic stability of financial market.

21) *What kind of incentives could help promote better long-term shareholder engagement?*

22) *How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?*

On the level of rules of corporate governance much can be achieved to foster a more long term view from the part managers and shareholders. Many innovation are already contained in the CRD 4. They should be rapidly implemented. However, we also believe that, to avoid legal hypertrophy we should leave to the market the time to implement the already existing new rules according to the general principles already contained in the EU existing legal setting.

23) *Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?*

24) *To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?*

25) *Is there a need to develop specific long-term benchmarks?*

A **specific LTI-benchmark** could lead to more transactions, and as a consequence to higher liquidity in the markets concerned will result in more attractive investment opportunities.

However it should be taken into consideration that an overall LTI-benchmark as such may not be the optimal solution, if at all possible from a practical point of view. Benchmarks for separate illiquid type of asset categories (and maybe even subclasses within specific asset categories) focusing on the different risk-return profiles of these categories therefore seem preferable.

Data will be key in this respect. Industry-bodies could play a big role in this respect. Institutions like the European Association for Investors in Non-listed Real Estate (INREV) and the Institutional Limited Partners Association (ILPA) may serve as proper examples. Also, the development of similar industry-bodies for other, not yet 'covered' illiquid asset categories / business sectors could be promoted by the EU and the national governments.

26) *What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?*

27) *How could securitisation instruments for SMEs be designed? What are the best ways to use securitisation in order to mobilise financial intermediaries' capital for additional lending/investments to SMEs?*

Securitisation instruments for SMEs should be designed in a very simple and straight forward manner. This is already reflected in current European securitisation transactions which have been issued after 2009.

Incentivising investors to invest in SME securitisations by e.g. lower capital requirements, once certain standards (such as highly granular pools, transparency, retention requirements, no originate-to-distribute, real economy related assets, etc.) are met, or the ability to use them in the LCR could be ways to mobilise more funds.

28) *Would there be merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitised products specifically designed for SMEs' financing needs?*

Creating a fully separate and distinct approach for SME securitisations is not necessary. A focus should be lying on whether the transaction serves a purpose of financing the real economy or not. Additionally, SME securitisations should only be used based on parts of the bank or leasing book, which have already a sufficient history on loan performance (e.g. at least 5 years or more).

We do not see the need to develop a new market product for SME, as there is already an existing market for SME securitisation. The main goal should be to revive the old SME securitisation market and getting investors interested in the market again (cf. answer to question 27)

29) *Would an EU regulatory framework help or hinder the development of this alternative non-bank source of finance for SMEs? What reforms could help support their continued growth?*

With all the reforms undertaken by the regulator, we see securitisation as one of the best regulated capital market products. The regulation has increased transparency, a better alignment of interest via the retention rule, investor knowledge has improved, monitoring processes have been installed, etc.

We therefore currently see no need for further regulatory adjustments to enhance product quality. However, the creation of an EU regulatory framework for SME securitisation might nevertheless be helpful to re-establish the market segment and restore investor confidence. The beneficial effect might become similar to the one experienced in regulated covered bond

markets. In our view, one should refrain from a too narrow definition of SME securitisation and broaden the scope of any SME related considerations to high quality asset classes like i.e. lease securitisations and Auto ABS, which are also supportive for SMEs. Key concerns which should be addressed in such a regulatory framework are current regulatory proposals regarding capital requirements for securitisation exposures of banks and insurance companies. It would be essential from our point of view to better reflect the different quality levels of securitisation products (i.e. current European SME securitisation vs. pre-2007 US subprime RMBS) in the capital requirement for securitisations. As in the case of covered bonds, a preferential regulatory treatment for high quality asset classes of the EU securitisation market should be considered, in order to create a level playing field for these two important instruments of secured financing.

30) *In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of the European economy?*

In conclusion, long term investment plays a fundamental role in sustaining growth, fostering competitiveness and ensuring the conditions necessary for financial stability and the consolidation of the public finances.

In the current economic environment, resources for funding LTI can no longer come primarily from government budgets (which are squeezed by fiscal imbalances) or from banks (which are restructuring and under pressure from Basel III). We need to create the conditions for promoting the entry of private capital. More specifically, institutional investors can play an increasingly important role.

However, substantial changes in public and regulatory policies and new financial instruments are needed, both at the European and at a global level, to encourage, or at least not penalize, LTI.

FeBAF recent publications

- Ignazio Angeloni (Banca Centrale Europea): “Verso un’Autorità di vigilanza per l’area dell’euro”, in Incontri f n. 1, 2013
- Pierluigi Gilibert (Banca Europea per gli Investimenti): “Strumenti finanziari previsti dalla BEI per il rilancio dell’economia europea”, in Incontri f n. 2, 2013
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- Carlo Cottarelli (Fondo Monetario Internazionale): “Towards a European Financial Transaction Tax?”, in Incontri f n. 4, 2013
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The Italian Banking, Insurance and Finance Federation (FeBAF) was established in 2008 by the Italian Banking Association (ABI) and the National Association of Insurance Companies (ANIA). Since 2010, other business associations of the Italian financial market have been joining the Federation. Assogestioni – the Italian Association of the Investments Management Industry – was admitted in May 2011, and Aifi - the Italian Association of Private Equity and Venture Capital – in January 2013.

The mission of the Federation is to promote the economic and social role of banking, insurance and finance in Italy and abroad, while upholding the general interests of the country. A modern and effective financial sector is an important condition for sustainable growth of society and the economy. Furthermore, FeBAF aims at presenting its member associations’ views and opinions on economic and social matters in all the relevant policy, institutional and economic fora, at the national and international level. FeBAF promotes business values, acting to spread the culture of competition and the market economy, and focusing on the enhancement of banking, insurance and finance in terms of transparency, trust-worthiness and performance to the benefit of customers, savers and the population at large.

Since its establishment, FeBAF has focused on a selected number of topics relevant for both the financial industry, and national, social and economic development. Due to the international orientation of FeBAF activities, its four member associations have decided to concentrate their liaison offices with the European institutions in Brussels in a single Office managed by Febaf. Thanks to such common lobbying and institutional presence, the Italian financial industry aims at strengthening dialogue with other organizations and stakeholders in Europe, and beyond.

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