Financial Services

Financial Services User Group's (FSUG)

reply to the

Green Paper on Long-Term Financing of the European Economy

Financial Services User Group

1 July 2013

FSUG c/o European Commission
Internal Market and Services DG
SPA2 4/69, BE-1049 Brussels
markt-fsug@ec.europa.eu

FSUG was set up by the European Commission to:

- advise the Commission in the preparation of legislation or policy initiatives which affect the users of financial services
- provide insight, opinion and advice concerning the practical implementation of such policies
- proactively seek to identify key financial services issues which affect users of financial services
- liaise with and provide information to financial services user representatives and representative bodies at the European Union and national level.

FSUG has 20 members, who are individuals appointed to represent the interests of consumers, retail investors or micro-enterprises, and individual experts with expertise in financial services from the perspective of the financial services user.

GENERAL REMARKS

The FSUG welcomes the Green Paper and finds the topic of the Green Paper extremely important for stable growth of the European economy. One of the most devastating for consumers are economic crisis, that always put them in a disadvantageous situation. Furthermore consumers, due to individualization of financing of social risks, require financial vehicles to transfer savings or pools the costs over a longer period. However it should be underlined that if economy needs to generate and attract savings there should be also a fair offer to consumer.

The capital flow to the real economy is provided by financial intermediaries, the most important of which, in a market oriented economy, are capital markets and the banking sector. There is general consensus that during the last three decades, in Europe, the banking system has been developing at considerably increasing rate as compared to the real economy, leading to high levels of financial leverage for all main sectors of the economy (namely governments, corporate and consumers). During this time the European banking sector has followed a path of shifting their main practices to the so-called financial economy rather than in the real economy applying the "universal" banking proprietary trading. Additionally, the main financial capital markets have been the subject of short-termism by institutional investors. These investors have a much "shorter-term" horizon as compared with the corresponding horizon of consumers and micro-investors.

This short termism is one of the main causes of the economic crisis suffered in Europe. This practice has to change if the European economy is to be sustainable in the long term. However, the strategies adopted to address the problem are questionable, as the deleverage procedure and the specific tools used in this context namely austerity measures, bail-outs at the expense of tax-payers, bail-in of unsecured deposits etc., have had consequences that jeopardize the main goal of stabilizing the financial system. To name just a few consequences, austerity measures leave economies dry of liquidity, while accelerating consumer over-indebtedness, bail-out measures increase levels of government debt, and dispute the trust of holding and increasing savings. It is thus indeed a very difficult task to foster growth in an environment with features as described above.

The context described above should be carefully examined in order to suggest the right means of long-term financing of the European economy. For example, although we believe that the goal of deleveraging is correct in principle, substituting the diminished role of banks with attempts to foster the growth of capital markets does not seem to be enough. For example, SMEs denote that their most pressing problem is first "finding customers", while "access to finance" comes second[1] which shows that small enterprises are mostly hit by contracting policy (note that "finding customers" is the main means of financing for any enterprise). Furthermore, small enterprises will, by definition, not be able to have access to capital markets, as the latter are designed mainly for larger enterprises. So, a main question that arises is how the 99% of total European enterprises, or even worse, the 92% which consists of micro enterprises, will finance operations and investments in an environment of gradually lower consumption, no access to capital markets by definition and more difficult and more expensive access to bank financing. Furthermore, capital markets are significantly volatile, meaning that in times of crisis they do not seem to be always the right means of raising capital; this should also be taken into consideration.

Thus, assuming that the economic policy remains unchanged, we see two distinct sets of measures that should be taken under consideration. The first set of measures refers to

[1] ECB biannual survey: http://www.ecb.int/pub/pdf/other/accesstofinancesmallmediumsizedenterprises201304en.pdf?bfe5ed21d3b6d2d9b6a81a6aa336f63f

corrections in the existing financial system and its micro-foundations, while the second set of measures refers to alternative tools / channels of long-term financing of the real economy.

Regarding alternative tools / channels of long-term financing, we believe that:

- Commercial banks must be separated from investment banks. This (among others) would facilitate capital flow to the real economy, as the main operation of commercial banks would be to provide financing to the real economy.
- Alternative sources of financing should be promoted and carefully examined.[2]
- Specific financial intermediary institutions should be developed to meet the needs of micro and small enterprises, that could be able to combine financing tools of different features (for example combine grants and debt financing, provide guarantees in cases of lack of collateral etc.)
- The role of state banks must be upgraded, to create financial institutions that should focus more on development issues rather than profit maximization drivers.

Furthermore we ask the European Authorities to focus on the root causes of the insufficient long term financing of the European economy:

- First rehabilitate equity investments, in particular by individual investors, as households are the main source of funds to finance investment (as recognized by the Green Paper), and as they have mostly long term savings goals (housing, education, retirement): equities are indeed the most long term, simplest , most liquid and cheapest to buy and hold long term investment product.
- Stop the destruction of the value of long term and pension savings[3], for which financial intermediaries and Governments bear responsibility, more than the actual performance of capital markets;
- Revert the fragmentation and reintermediation of long term capital markets that have been accelerated by MiFID I and make end investors less dependent on intermediaries;
- Align investment intermediaries' incentives to those of their clients
- Improve the corporate governance of listed companies, facilitate shareholder engagement, and better identify and sanction large market abuses
- Improve the compliance of institutional investors with their fiduciary duties and formalize rules and supervision for its exercise.
- Simplify and improve rather than add to the existing complex and too long list of long term investment products in the EU.
- Adapt and harmonize prudential regulation not to unduly penalize investments in equities and other long term assets when they are funding long term liabilities whether the institutions involved are insurance-regulated or not. Of course there has to be adequate provision against the risk of those assets not meeting future liabilities.
- Special attention should be paid taxation of savings in the EU favours long-term savings and investments in the real economy; tax incentives should promote long-term investments and there is a need for tax simplification to allow easy calculation after tax investment returns, especially for pension products; very often there is a double taxation of cross-border dividends within the EU, and EU Financial Transaction Tax ("FTT")

---

[2] FSUG is already developing a paper regarding this particular issue of alternative ways of financing.

[3] As evidenced in « the real return of private pensions »,, a research report published by the European Federation of Financial Services Users, June 2013.

schemes supposed to aim of financial institutions not the EU citizens who already bear the costs of crisis.

Questions:

1. DO YOU AGREE WITH THE ANALYSIS OUT ABOVE REGARDING THE SUPPLY AND CHARACTERISTICS OF LONG-TERM FINANCING?

FSUG generally agree with above study, however within supply analysis more attention should be paid to consequences of demographic structure changes and pension reforms. There should be a synergy between long-term financing of European economy and the needs of European citizens.

We do not agree on the fact that short-term savings are the most preferred saving instrument for households. Households have mostly long-term saving needs; if they use short-term investment instruments it is often because they are pushed to do so by intermediaries, by fiscal incentives, and by the poor results of "packaged" long term products.

The Commission acknowledged this key issue (regrettably not in the green paper itself) but in its Staff Working Document), rightly pointing out that one of the reasons why households may not invest long-term is the "*often poor performance of financial intermediaries to deliver reasonable returns, and the costs of intermediation*"[4]. But even the Working Document stops short of analysing how poor these returns are and why so. Net real (net of inflation) returns of pension savings have been on average negative over the recent past, and the main reason is the very high amount of fees and commissions charged year after year on "packaged" long term and pension products[5].
One should not expect - and even more so push - EU citizens to continue and to increase their investments in such long term value destroying products.

It is time for European Authorities to eventually implement the guidance of the 2007 EC Green paper on retail financial services: *"Due to the nature of long-term savings and pension plans, particular care is needed to ensure that consumers are being offered products that are really adapted to their needs and marketed appropriately. These are major, once in a lifetime, financial decisions for consumers. Therefore, consumers must be in a position to make their choices in full knowledge of the product, correctly assessing their circumstances and needs"*[6]. We could not agree more with the Commission's diagnosis; however the necessary and effective implementation of these objectives has yet to come.

In particular, the MiFID and KID investor information and protection rules MUST be extended as soon as possible to all long term and pension savings products. Full costs and benchmarked past performance must be made totally transparent at last. It is a very high concern for financial services users to see that the current "PRIPs" initiative (Key Information Document for Investment Products) excludes from its scope a lot of long term products. It is also a high concern to notice that the current Insurance Mediation Directive Review ("IMD II") does not align its client protection provisions to the much better standard of MiFID. Pension savers have also yet to see if the EC will try to extend these customer protection rules to occupational pension products through the upcoming "IORP" review.

[4]Commission Staff Working Document "Long-Term Financing of the European Economy" accompanying the Green Paper on Long Investment, European Commission, 25 March 2013, page 10 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2013:0076:FIN:EN:PDF

[5] « the real return of private pensions » - see footnote 1

[6] European Commission: Green paper on retail financial services, 2007.

We are concerned by the fact that the "Corporates" section seems to refer only to larger enterprises, while there is only one sentence for SMEs and this focuses on liquidity. SMEs are the backbone of the European economy and the *"key driver for economic growth, innovation, employment and social integration"*[7]. The EC has been actively developing a Policy for the SME sector during the last decade. SMEs used to rely on internal funds to finance their operations at a much higher level when compared with the current economic situation. Specifically *"In terms of sources of financing, there appears to be a sizeable downward shift since 2009 in SMEs using internal funds (i.e. retained earnings or sale of assets) to finance their activities. In 2011, 24% of EU SMEs reported using internal funds while in 2009 it was 49%, - a decline of 25 percentage points. The greatest falls are found in Greece, Ireland and Sweden"*[8]. The contribution of SMEs in supplying long-term financing should not be underestimated.

2. DO YOU HAVE A VIEW ON THE MOST APPROPRIATE DEFINITION OF LONG-TERM FINANCING?

We find the definition of long term financing of the G20 much more appropriate and clearer than other alternative definitions which do not set any maturity threshold, such as *"LTI is a process by which the financial system provides the funding to pay for investments that stretch over a period of time"*. We agree with the LTI Green Paper on the fact equities' features make them a good candidate to be the standard source for the long-term financing of the real economy: no maturity, and a possibility to influence the long-term performance of the companies which benefit of the funding from the investor. Therefore, we would like to encourage the European Commission to act accordingly and consider equity investment as a cornerstone of their proposal for the long-term investment strategy of the EU. At the same time we see the need for measures to prevent speculators and other corporate raiders undermining long term investment decisions.

Within a definition of long-term investment there are also products provided by states which are extremely valuable as benchmark for the rest of the financial market, for example long-term inflation bonds or securities based on changes of demographic structures. One cannot ignore such inventions within long-term financing.

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?

Banking industry has a lot of extremely valuable experience and resources concerning evaluation of new business projects and start-ups, and this work should be continued. However firms with long "credit" history should have easier access to non-banking financing.

The after-crises role of banks depends on their shape after the sector is reformed. If commercial banks are separated from investment banks, the main role of the new commercial banks is expected to be better suited to the financing needs of the ***real*** economy. In any case however, the deleveraging procedure is expected to balance the European economy in levels of lower leverage than before, meaning that the role of banks is expected to be diminished, leaving space for other ways of 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? HOW COULD FINANCIAL

[7] http://ec.europa.eu/enterprise/policies/sme/

[8] http://ec.europa.eu/enterprise/policies/finance/data/enterprise-finance-index/european-surveys/sme-access-to-finance-survey/index_en.htm

INSTRUMENTS UNDER THE EU BUDGET BETTER SUPPORT THE FINANCING OF LONG-TERM INVESTMENT IN SUSTAINABLE GROWTH?

One could think about some incentives for selected products; however it should be stressed that such incentives should not undermine economic soundness and efficiency. Special attention should be paid to small and medium projects, as they require more advantageous conditions for successful continuity.

We think that other development banks than those mentioned in the Green Paper such as the European Bank for Reconstruction and Development and the World Bank, should also be engaged with the described EU-wide financial instruments currently managed by the European Commission, the EIB and the EIF. Increasing the coordination between all these bodies seems a good measure to us, especially that such initiatives seem somewhat uncoordinated and overall unclear.

For instance, we learned of two different programmes aimed at strengthening corporate governance in Romania organized by the World Bank on the one side and by the EBRD on the other. We wonder whether these initiatives are in any sense coordinated between both organizations and with the EU ones to increase the potential impact and returns of public spending. Also, we observe that these initiatives too often consist in giving public funds to commercial consultants which in turn ask NGOs such as organisations represented in the FSUG to provide evidence and analyses to them for free. Public multinational funding institutions should better ensure they reach out to the user and civil society organisations.

We would also support the increase the transparency of such institutions and especially to strengthen their governance not only to guarantee the correct performance of such long-term objectives but also to facilitate the understanding and engagement by other stakeholders in such long-term initiatives.

The after-crises role of banks depends on their shape after the sector is reformed. If commercial banks are separated from investment banks, the main role of the new commercial banks is expected to be better suited to the financing needs of the ***real*** economy. In any case however, the deleveraging procedure is expected to balance the European economy in levels of lower leverage than before, meaning that the role of banks is expected to be diminished, leaving space for other ways of financing.

5. ARE THERE OTHER PUBLIC POLICY TOOLS AND FRAMEWORKS THAT CAN SUPPORT THE FINANCING OF LONG-TERM INVESTMENT?

Public-private partnership with mix resources could incentivise local communities and entrepreneurs to invest in long-term regional projects. Such projects should not overwhelm local administration and community.

6. TO WHAT EXTENT AND HOW CAN INSTITUTIONAL INVESTORS PLAY A GREATER ROLE IN THE CHANGING LANDSCAPE OF LONG-TERM FINANCING?

Institutional investors could play a huge role and we would like to underline fiduciary duties. Stock lending by institutional investors to speculators/short sellers could increase liquidity of the market however at the same time it introduces a conflict of interest and can be against the long term interests of firms and other investors.

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 Solvency II regime takes as granted that there is nothing like full guarantee. The longer the period of guarantee the lower level of certainty there is concerning final outcome. However prudential rules are to increase the possibility of required outcome and should also examine to what expect declared outcomes are realistic and institutional investors are doing everything to achieve promised performance. The longer period of investment the more importance is corporate governance and the less important is a value of required minimal capital. The capital requirements should be linked to short term liabilities rather.

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

There is such possibility, however better rating system dedicated to long-term investments is required that allows assessment of probable future real performance and provides clear information about the risk, which should be structured into few clear layers. To increase competition among providers maximum possible transparency is required and high standards of corporate governance.

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

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?

New prudential regulation put strong accent on capital requirements and asset market valuation increase procyclicality and run sales of the most volatile assets, shares. Similar rules apply in this respect for Basel II/III and Solvency II. But one should mention also revision of IORP, which pretended to follow this direction. Provision of long-term investment requires special rules, not less strict, but different, mainly based on ability to continue running a business.

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

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?

See comments below about the risks associated with infrastructure investments

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

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?

(Ad. 11-14) The after-crises role of banks depends on their shape after the sector is reformed. If commercial banks are separated from investment banks, the main role of the new commercial banks is expected to be better suited to the financing needs of the ***real*** economy. In any case however, the deleveraging procedure is expected to balance the European economy in levels of lower leverage than before, meaning that the role of banks is expected to be diminished, leaving space for other ways of financing.

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?

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

(Ad. 15-19) The structure and level of taxation is an issue that exceeds the narrow scope of this green paper. Countries compete by lowering corporate tax rates to attract capital, while simultaneously losing huge taxable income mainly of large corporations that head to off-shore practices. This is happening in a context of fiscal consolidation which creates unfavourable conditions for citizens. This is the context that CIT reforms and tax incentives are being approached and the context should change.

Focusing on the scope of this green paper, it is indeed true that the tax system favours debt financing due to interest deductibility and this distortion should indeed be tackled under the main goal of deleveraging the economy.

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?

Fair value is very valuable concept, which allows monitoring present performance of managers. However it cannot be the only measure of investments with long maturity period, as volatility of the capital market should be interpreted with a caution. There are two ways fair value accounting could be misinterpreted. The first, as information to investor, mainly retail investor, who executes fire sale of volatile assets, with all possible consequences. And the second is usage of market consistent valuation within formula of capital requirements.

Fair value is defined under IFRS as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties, in an arm's length transaction. For that, quoted prices in active markets must be used. In the absence of such prices IAS 39 allows the use of valuation techniques which gives room for adjustments. Contrary to prudential accounting, fair value accounting reflects current market conditions and therefore may be misleading for assets held for a long period of time and to maturity. Furthermore, the use of fair value accounting principles has led to a high volatility in the valuation of assets. We therefore agree that there is merit in examining further whether fair value accounting standards are fit for purpose when it comes to long-term investment.

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?

23. IS THERE A NEED TO REVISIT THE DEFINITION OF FIDUCIARY DUTY IN THE CONTEXT OF LONG-TERM FINANCING?

(Ad. 21-23) Promoting long-term investments is crucial for the wellbeing of EU citizens and the development of the EU economy. In our responses to the Green Paper on EU Corporate Governance framework[9] and the UCITS VI long term investments[10] we have already pointed to existing legal rules that contribute to inappropriate short-termism among investors and have made concrete proposals how to tackle them. In addition we consider that certain economic incentives can be an appropriate means to support long-term shareholder engagement. An enhanced dividend for long-term investors as it is already existent for example in France would surely be one option to promote long-term engagement among investors. FSUG on the other hand is not in favour of increased voting rights for long-term investors as this would contradict the "one share – one vote" principle. Moreover, we consider that investors should be enabled to exercise their voting rights to exercise their fiduciary duty as owners of the company. Here we would like to point to the EuroFinUse report on "Barriers to Shareholder Engagement"[11] which clearly shows that shareholders currently have enormous problems to exercise their rights/duties as shareholders – the voting right/duty – on a cross-border basis.

Regarding asset management, we consider remuneration incentives as being one of the most influential factors to influence asset managers' behaviour. We consider that capping bonuses for asset managers as it is proposed in the draft UCITS V Directive combined with a limitation of short-term performance fees for asset managers to the benefit of long-term incentives would encourage asset managers to focus on long-term investment strategies and relationships. Remuneration policies and practices need to be compatible with the obligation to act fairly, professionally and in the best interest of the client.

---

[9] http://ec.europa.eu/internal_market/finservices-retail/docs/fsug/opinions/corporate_governance-2011_07_20_en.pdf

[10] http://ec.europa.eu/internal_market/finservices-retail/docs/fsug/opinions/ucits_long_term_investments-2012_10_18_en.pdf

[11] http://www.eurofinuse.org/fileadmin/user_upload/documents/Research_Reports/FINAL_Barriers_to_Shareholder_Engagement.pdf

We further consider that all parties in the investment supply chain (and not only those who have direct contact with the client) should be considered as exercising a fiduciary duty. Not only the point of sale but also at the intermediaries' level any misalignment of interests can result in damages for investors and the capital market as a whole. Any definition of "fiduciary duty" should therefore address the whole investment distribution chain – from the manufacturer to the sales staff.

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?

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?

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?

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?

(Ad. 26-29) As mentioned above, "Access to finance" is the second most pressing problem for SMEs (with high variations among countries) and looking at the future their access to bank financing, which is the main source of external financing for SMEs, is going to be more expensive and more difficult.

At first we need to pay particular attention to the fact that the SMEs definition is so broad that there exist great differences between a micro and a medium enterprise. On top of that note that 92% of total enterprises in Europe are micro.

We doubt that venture capital is a good alternative for SME financing. The main consideration refers to the fact that there is a graduate and steady fall in the number of enterprises financed by venture capital, irrespective of the total volume of venture capital in place, meaning that there is a graduate trend that the relative size of SMEs to gain access to this type of financing is continuously raising[12]. Venture capital does not seem to be an attractive tool for micro and small enterprises.

In a similar context to the above, capital markets for SMEs seem to be better suited to the larger part of SMEs.

[12] See: Kramer-Eis H., Lang F. and S. Gvetage, "European Small Business Finance Outlook", Working Paper, European Investment Fund Research and Market Analysis, December 2012

Regarding securitization, we have expressed our concerns regarding this process as a whole in question set 11-14.

Non-traditional sources of finance seem to be the only interesting practice that could indeed provide a solution to micro and small firm financing.

Generally, there seems to be a lack of financial institutions that could develop financing instruments to meet the needs of small enterprises. These institutions should first assess the real financing needs of SMEs and develop financial instruments that could be able to combine financing tools of different features (for example combine grants and debt financing, provide guarantees in cases of lack of collateral etc.)

As a last remark, note that the most pressing problem of SMEs is *"Finding customers*". This is translated in low demand and implies that the general economic policy followed in EU level is affecting the most the sector of SMEs.

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?

We would like here to underline the potential risks of promoting infrastructure investment. Sometimes this may be a good idea for pension scheme members but a bad idea for citizens – especially future generations who could end up paying a huge risk premium to fund important public projects. Moreover, not only could it be more expensive to fund infrastructure through private infrastructure funds (the risk premium) compared to government bond funding, private investors are demanding that states still underwrite the cash flows on infrastructure investments. So, citizens could lose out both ways. Infrastructure funding in essence represents a potentially huge transfer of risk from one set of citizens to another. However, it simply introduces significant financial intermediation costs into the system. So the winners could be financial intermediaries and institutions not citizens.