European Commission Green Paper on Long-term Financing of the European Economy

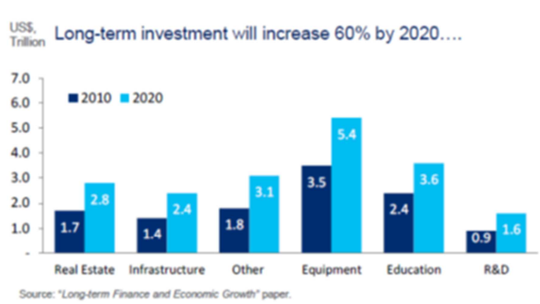
14 June 2013

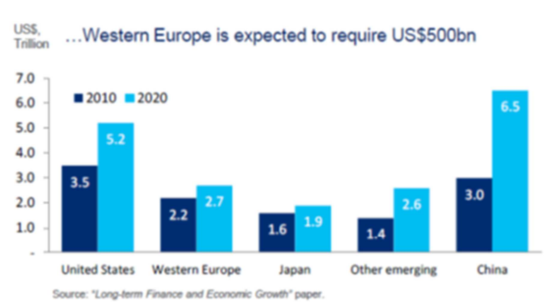
1. *Introduction*

The International Regulatory Strategy Group welcomes the opportunity to comment on the European Commission's Green Paper on long-term financing of the European economy. The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to be one of the leading cross-sectoral groups in Europe for the financial and related professional services industries to discuss and act upon regulatory developments.

We welcome the Commission's opening of the debate on the role of financial services in providing funding to the wider economy and how this must change in the face of demographic, economic and regulatory changes, and agree that there is an important discussion to be had on this issue. The academic literature has robustly established that financial development is not only the consequence of economic growth but also a driver[1]. If the EU is to achieve the ambitious goals for unleashing private enterprise and creating jobs set out within the Europe 2020 agenda, then it cannot afford to overlook the role of the financial system in fostering innovation and growth.

Forecasts predict substantial funding needs and long-term investment will be crucial to achieving future productivity gains





By 2020, nine major economies will need to invest an additional US$7 trillion annually to support growth including US$1 trillion in infrastructure assets[2]. However, it is important to avoid the temptation of identifying long-term investment only with infrastructure, which is merely one component of investment. All parts of the economy and the spectrum of asset classes should be considered part of long-term financing. Net new issuance (i.e. ignoring

[1] Oxford Economics (2011), Balancing growth and stability in EU financial reform, May 2011
[2] Group of Thirty- Working group on Long-term Finance, Long-term Finance and Economic Growth (2013)

refinancing of existing debt) required by European corporates could be as high as €195 billion[3]. Companies will need to attract diversified sources of financing given the shrinking pool of bank liquidity, particularly at longer tenors.

This is an issue that the IRSG has already been actively pursuing and in collaboration with CBI, Paris Europlace and MEDEF, we have produced a set of papers examining how financial services, and in particular the wholesale financial markets, can provide the financing to enable companies to grow throughout the business cycle (see separate submission). As well as gaining access to a mix of funding sources, a key issue is facilitating the transition from start-up to SME to mid-cap and the appropriate funding to accompany such a transition. For example, venture capital, private equity and bank funding for a fast-growing start-up can provide a stepping stone to the capital markets once the company has matured. It is worth noting that the SME definition includes a wide range of business, from microbusinesses to intermediate-sized companies just below the size to be able to access the capital markets.

It is important to note that financial services firms are already involved in long-term financing of companies and infrastructure, such as healthcare, transport, energy, etc. and we welcome the opportunity that this consultation provides to work with policymakers to improve and facilitate this activity, as well as share best practice across the EU.

Nevertheless, we note that some of the areas covered within the Green paper, for example in the field of taxation, are not in the first instance within the Commission's competence and we believe that given the disparate economic models in the EU, these issues would be better addressed at a national level, according to the principle of subsidiarity. That said, the Commission could helpfully focus its recommendations as part of the European semester on actions that would most benefit long-term finance and growth.

We would also challenge the perhaps unintentional perception that long-term equals good and short-term equals bad. For retail investors particularly, managing future liquidity requirements may be as important as long-term saving. What may be perceived as "short term" investment can also in fact be an enabler of long-term investment. In addition, corporate often require a diverse menu of short and long term financing options to meet their growth and investment objectives.

In our view, the main recommendations to improve long-term finance are:

- To remove barriers for insurers and sovereign wealth funds to invest in long-term assets rather than only government bonds;
- To consider lowering the higher risks involved during the early stages of long-term projects through the use of risk mitigation mechanisms such as credit/risk guarantees, first loss provision, public sector subsidies and the availability of swaps;

[3] IRSG (2013), Wholesale Financial Markets: Growing a business organically through long-term finance, p.2

- To ensure a stable and proportionate regulatory system, including structures that ensure that any decision taken by regulators or governments that would affect contracted investment returns are taken within a clear and transparent framework and do not have retroactive effect.
- To foster the development of long-term pension and insurance-based savings (for example by setting up compulsory auto-enrolled savings programmes);
- To foster the development of a European private placement market, complementary to public capital markets, similar to the US;
- To preserve and promote the concept of market making in the wholesale financial markets as an enabler of efficient and orderly markets and critical to long-term finance.
- To support SMEs and intermediate-sized companies by facilitating their access to capital and investors, and facilitating their transition along the funding escalator; and
- To develop a framework which is attractive to international capital, in particular with regards to state-sponsored procurement and third country access provisions in financial services legislation and to promote the importance of hub financial centres as a means of attracting international capital.

2. *The need for strong liquid capital markets*

While banks have traditionally provided long-term financing, the post-crisis regulatory environment has restricted their ability to do so and capital markets will have to fill the gap create by the growing demand for long-term finance.

Compared to the United States, European Capital markets are less liquid, provide shorter tenors and offer a lower variety of financial instruments. Capital markets are momentum driven: successful issuances allow companies to raise debt at cheaper levels; and strong market appetite can be demonstrated by an increase number of issuances.

A company's financing needs depends on a range of factors. It requires a combination of finance sources that cater to both short term and longer term needs. Sources of external long-term finance include bank credit, and capital markets financing through corporate debt and equity investment. It is important to recognise that these sources of financing complement each other. A company will often choose an appropriate mix of funding across each source.

The main objective of an EU long-term financing strategy must be to ease the access of SMEs to capital markets and offer the right opportunities for savers to invest in innovative products, projects and growth stories. This will help provide a more diverse and sustainable business finance landscape in the EU. If the capital markets at the top of the financing chain do not operate effectively for SMEs, earlier stage investors - including business angels and the venture capital community - will have a diminished appetite to invest in SMEs at an earlier stage in their development, thus stifling EU economic growth.

There must also be a commitment to preserving the market maker model which enables asset managers, corporate, insurers, pension funds, and other end users of markets to buy and sell financial instruments with greater certainty and thereby creates deeper capital markets in which SMEs can raise finance. Market makers buy and sell when markets are imbalanced and building and hold inventory to meet future demand. In many markets, market makers provide the vast majority of the liquidity, and can be the only providers of liquidity in times of stress, when other market participants may withdraw. Various pieces of recent EU regulation introduce a definition of market making – often crafted in a narrow fashion and specific to the particular piece of legislation – which in turn can have adverse consequences to market liquidity and access to capital markets. While market making as a concept can be challenging to define, the Commission should ensure that any definition of market making in future EU legislation looks at the totality of a market participant's activities versus individual trades, so as to preserve the provision of liquidity benefits needed to broaden access to the capital markets.

The Commission should also develop a "think small first" approach to capital markets regulation. Regulatory barriers reducing issuer and investor access to the capital markets increase the cost of capital for SMEs and need to be removed. A consistent approach to SMEs across Directorates is needed.

Any regulatory requirement that discourages the use of one source of funding over another should be reviewed (e.g. Solvency 2, the Basel 3 Net Stable Funding Ratio, and the proposed FTT).

i. The purpose of capital markets

The purpose of capital markets is twofold – to provide access to finance for companies, and to generate returns for savers and investors. To facilitate this, markets provide a means of financial intermediation between savers and companies. Financial intermediation enables savers to achieve diversification (of their portfolios) and liquidity, and for companies to access a pool of capital provided by a diverse range of investors to support the growth of their businesses.

Effective intermediation reduces risk and permits the time horizons of savers to differ from the time horizons of companies, enabling efficient use of capital in the economy.

ii. The need for, and benefits of, strong liquid capital markets

Strong and robust liquidity is a necessary condition for capital markets to fulfil their purpose, through effective financial intermediation. Liquidity is vital as it reduces the cost of capital for both investors and companies by:

- Narrowing "spread costs" between buy and sell prices and thus reducing costs for savers and investors.

- By reducing this liquidity premium demanded by investors, it then reduces the cost of capital for companies.[4]

There is an extensive body of evidence on the link between liquidity and the cost of capital for companies. Domowitz and Steil (2001)[5] estimated that a 10 per cent increase in transaction costs increases the cost of capital (as measured by the post-tax cost of equity) by between 1.4 per cent and 1.7 per cent. Research by Oxera has indicated a 'small firm' effect, which makes SMEs more vulnerable to market illiquidity[6].

From an end-investor perspective, liquidity helps provide certainty over exit options – as all investors expect to realise their investment at some point in the future, depending on a number of factors including their opportunity cost, risk appetite, investment horizon, and macroeconomic conditions.

Liquidity also enables investors to benefit from narrower spreads and reduced volatility, and consequently lower trading costs. This enables them to secure a better price, resulting in better returns on investment[7].

iii. Liquid markets do not mean "short-term" markets

The economic significance of liquidity is the ability of investors to realise significant stakes in a medium term time scale at realistic prices, and to do so even in turbulent market conditions. However, trading in markets is essential for this. Without liquid markets, the time horizon of savers would differ from the time horizon of corporations. This would increase the cost of capital for companies, and frustrate the use of capital in the economy for long-term investment.

We would advise against using share turnover data as a measure to assess how long investors hold shares. The turnover of beneficial ownership data, instead, is a more accurate metric to use. The use of share turnover data as a proxy for average holding periods of shares is inappropriate as this metric accounts for all shares that trade, but does not represent change of beneficial ownership in a company's share register. Many registers remain reasonably fixed and stable, and only a small proportion turns over quite quickly.

For example, 60 per cent of the London Stock Exchange Group's share register is owned by shareholders who have consistently held their shares for longer than three years – despite the LSE having a share turnover that in the last financial year peaked at 135 per cent (suggesting an

[4] As a company's cost of capital is the return that investors demand for their investment in the company, it increases with costs borne by the investor which in addition to due diligence costs, includes any upfront or future taxes on investment and uncertainty over exit options.
[5] Domowitz, I and Steil , B (2001), 'Automation, trading costs, and the structure of the securities trading industry',
[6] Grant Thornton, Economic Impact of AIM and the role of fiscal incentives, September 2010.
[7] London Stock Exchange/Oxera report ("The Cost of Capital: An International Comparison" – June 2006) refers to studies showing that the trading costs incurred by investors in secondary markets have direct implications for share prices and a company's cost of equity.

average holding period of nine months)[8]. It would, therefore, be more appropriate to consider the turnover of beneficial ownership. Initial analysis of company share registers shows that in 2011, 83 per cent of investors turned their portfolio over less than once every two years. Of that number, 20 per cent turned their portfolio less than once every four years. This shows the skewed nature of share turnover data in calculating average holding periods, and the long-term nature of many fund managers.

Thus, it is clear that companies can use short-term funding for long-term investment. For companies, liquid capital markets offer the diversity of longer-term and shorter-term investors with their different strategies and motivations, and a mix of domestic and international investment. This in turn lowers the cost of capital and makes it easier for companies to raise external finance (which is especially important for SMEs).

3. *The need for a stable and proportionate regulatory regime and the cumulative impact of regulation*

The Green paper correctly highlights the potential tension between the pursuit of financial regulatory reform in the EU and the drive to encourage long-term investment by the financial sector. Significant reforms to the capital and liquidity requirements for banks have already been adopted, with further measures to be introduced over the next few years. These could have significant implications for the incentives to invest in less liquid instruments. Increased collateral requirements of over-the-counter derivatives and proposals for structural reform of universal banks could all impact the appetite and ability of market participants to channel or undertake long-term investment. We also believe that the creation of large ex ante resolution fund is likely to reduce funds available for long-term financing from the sector.

Proposed prudential reforms for insurers under Solvency II encourage insurers to hold liquid assets, which tend to be short-term, but investing long-term, for example in infrastructure assets, better matches their long-term liabilities and makes a more meaningful contribution to economic growth than short term investment. Important issues remain with the Solvency II framework which must be resolved in order to avoid negative consequences for EU consumers, competitiveness of EU insurers and their ability to undertake long-term investment in the economy. A key issue is the treatment of long-term guaranteed products, such as annuities. 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.

Finally, with the importance of market finance in funnelling capital to contribute to the growth of the European economy, it is also necessary to revisit the merits and consequences of “shadow banking” reforms for European growth.

[8] As of 31 March 2011. Source: LSEG Regulatory Strategy.

The impact of the changes already underway needs to be understood before more proposals are introduced. Continued pressure on the sector (for instance through the introduction of transaction taxes) will inevitably have an impact on the availability and cost of credit and lending to the wider economy. A thorough cumulative impact assessment with respect to each new regulatory proposal should be completed that takes account of other initiatives recently implemented or currently being considered. Additional impact assessments should also be conducted if the final regulatory requirements have varied significantly from the original proposal covered by the initial impact assessment.

At a fundamental level, the uncertainty produced by a continually changing regulatory landscape, will in itself act to undermine the longer term strategies required if long-term investment is to increase. A stable and proportionate regulatory regime is a pre-requisite for proactive proposals to encourage long-term investment. The most important condition for long-term investors is a stable regulatory and political framework that offers legal certainty. Against the background of investments with maturities of ten, twenty or more years, it is essential that investors are confident with regard to the persistency and legal certainty of political and regulatory decisions. This means that structures and/or institutions are needed to ensure a consistent and transparent process for regulators or governments to make decisions regarding future contractual changes, and these should not have retroactive effects on the existing investment/project portfolios of investors.

The Commission should therefore encourage Member States to adopt principles that would reduce regulatory risk: a clear framework for the exercise of regulatory discretion; legal provisions for effective enforcement of decisions; and efficient rules of accountability.

i. IORP

It is difficult to comment definitively on what impact the current IORP Directive review may have on the ability of IORP's to make long-term investments. The review is not yet complete and we welcome the announcement on 23 May that the proposals for IORP 2 will focus on improving the governance and transparency of pension funds and will propose imposing solvency rules on pension funds and we welcome that the Commission will undertake further technical work in this area before coming forward with proposals for applying solvency rules to pension funds.

We feel it is important that any technical work conducted in the future around the solvency of IORPs should allow IORPs to continue and also increase their support for long-term investment. Extra returns that are available on long-term investment assets, which are often illiquid are ideally suited to match IORP's relatively illiquid liabilities, or the commitments made to their pension scheme members. These illiquid commitments mean that IORPs are able to buy long-term investments, and then hold these to maturity, so genuinely earning the extra returns available. IORPs and insurers, as a consequence of their illiquid liabilities, have business models that are able to support long-term investment assets, which are often of an illiquid nature.

ii. Long-term investment funds

The Commission is right to consider that a new long-term investment fund (LTIF) could facilitate the raising of capital across the Union. Carefully calibrated rules on LTIFs could inspire the same confidence as UCITS. 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. We believe that these funds should focus on small or medium sized institutional investors (local government pension trustees, for example) who can lack expertise in long term investment. From an asset management perspective, the Commission will need to consult with the industry and potential investors to ensure that this new framework will be fit for purpose There may be benefits to enabling retail investors to access the fund type but clearly they will require different rules than for institutional investors. We do not consider it likely that demand for direct investment in long term investment funds from retail investors will be high because of the generally short time horizons of consumers as well as their need for liquidity, especially during the current period of financial stress. Of course, this depends on the redemption rules, but given the illiquid nature of the assets there is a tension between fund redemptions and the effective management of it if liquidity is provided on a daily basis.

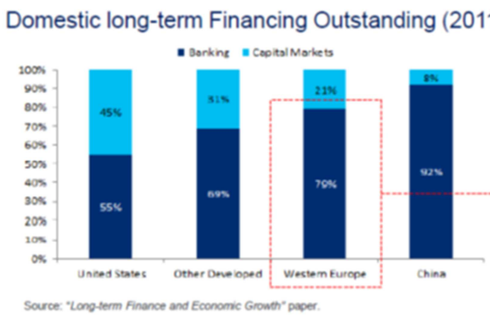
However, there may be investor demands for such funds in a pension scheme wrapper. The long-term savings nature of such a scheme could dovetail nicely with the long-term financing requirements of companies. Disclosure and transparency are paramount – if there is a significant lock-in period then this must be made clear upfront.

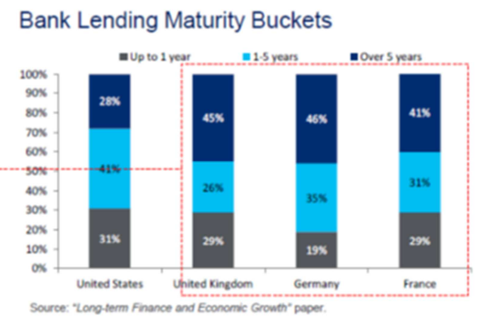
We note that there is reasonable recent activity in the "listed companies" space in infrastructure that indicates a significant appetite for listed vehicles owning infrastructure assets. These vehicles all own actual infrastructure assets, are listed and have both institutional and retail investors. The Commission should ensure that similar vehicles can be accepted in LTIFs.

4. <u>The role of banks and institutional investors</u>

i. Commercial banks

Historically, European banks have been the major provider of long-term financing. This means that long-term financing has historically been funded through institutions relying on short-term funding themselves, causing a structural mismatch.





The transformation of short-term deposits into long-term lending has come under stress post-crisis. In light of regulatory restrictions, such as the liquidity charges that have increased bank funding costs and more stringent capital requirements in CRD4/Basel III that have restricted longer tenor bank lending, a shift in the roles of banks from lenders to arrangers is likely to take place. Capital markets and institutional investors need to fill in the supply/demand gap occurring as a result of this change for banks. However, banks will continue to be drivers of unconditional lending (such as merger and acquisition finance or construction finance), private placements and capital market arranging.

In their new role as arrangers, banks will continue to play an important role in channelling products to the capital markets. In particular, banks already have historical relationship with companies and infrastructure in place to assess credit risk and underwrite loans, whereas capital market participants rely on public sources of credit-related data, such as credit rating agencies. Making use of this infrastructure (for example in securitisation) is important to facilitate greater use of capital markets for long-term financing and it is important that the regulatory landscape (for example CRD4 in relation to securitisation where increased capital charges for longer maturities are proposed) does not disincentivise banks from conducting this activity.

ii. Institutional investors

Long-term finance providers should have matching long-term liabilities. Investors with long-term liabilities such as insurance companies (in particular life insurers), infrastructure funds and pension funds are best suited to invest in long-term assets. Assets of institutional investors have grown substantially in countries with developed markets. In the UK, pension assets grew from 20% to 80% of GDP and insurance company assets increased from 20% to 100% of GDP between 1980 and 2009[9]. As a result, huge amounts of stable, long-term funding have been channelled into capital markets. However, in most of continental Europe, the role of institutional investors has historically been much smaller. Pension funds remained small because extensive pay-as-you-go (PAYG) systems were in place. Moreover, investments

[9] Trusted sources (2011), Insurance companies and pension funds as institutional investors : global investment patterns, November 2011

remained more focused on government bonds, partly due to stricter regulation. As a result, the financial system remained centred on bank lending. This has recently begun to change as institutional investors have grown and moved towards market-based financing.

However, the body of institutional investors is not homogeneous. Their risk profiles, investment horizons and required returns will vary greatly. The table below summarises some of these key differences:

	Equity Investors	Debt Investors
Examples of Investors	• Infrastructure funds • Pension funds • Insurance companies • Sovereign wealth funds • Private equity funds	• Commercial banks • Infrastructure banks • Capital markets • Institutional investors • Debt funds
Investment Horizon	• Medium term investors (most often private equity funds) achieve return through sale of the business • Long-term investors rely on stable dividend cash flows	• Banks' investment horizon has reduced in light of more stringent regulatory environment (Basel III) • Infrastructure banks could provide longer tenor • Capital markets are liquid up to 10–12 years tenor • Institutional investors invest in 10+ years
Expected Return	• Long-term investors would seek a return in the [low teens] for the life of the transaction • Medium term investors seek returns of [~20]%	• Debt investors would expect [4–6%] nominal returns (for an investment grade issuer)
Barriers to long-term Investing	• Management-led risk reduction strategies • Regulation (e.g. Solvency, shift from defined benefit to defined contribution pension schemes) • Low returns • Limited debt availability	• New regulation has lead to banks de-lever and shift focus to shorter term lending • Need for credit analysis skills including on-going monitoring • Require critical investment mass to justify use of resources
Suggested Incentives	• Easily available long-term debt funding, including increasing the range of debt instruments available • Ensure investors are better able to take a long-term horizon in their investment decisions • Incentivise savings	• Create more liquidity in capital markets, particularly for longer tenors by raising investor awareness • Incentivise institutional investors to be more active in the lending market • Incentivise savings

Investment patterns of insurance companies and pension funds vary widely among countries. In continental Europe, insurance companies and pension funds have had a much more conservative asset allocation than their counterparts in the UK and US. A large share of investment has gone into government bonds; generally less than 20% of assets were in equity. More recently, the importance of equity and corporate bond investment has increased but is still low compared to the UK and US.

The crucial difference between the liabilities of insurance companies and those of pension funds is that the latter are generally defined in real terms (i.e. a fixed percentage of the wage earned at retirement and are usually index-linked) while the former have historically been defined in nominal terms. This has meant that for pension funds, equities have been a better asset class to match liabilities as their value tend to move in line with nominal wages over the long run, while insurance companies on average invest more in long-term bonds and less in equities than pension funds do as bonds guarantee a fixed nominal return with limited downside risk. However, a shift towards participating and unit-linked insurance policies has shifted insurance companies' assets towards equities.

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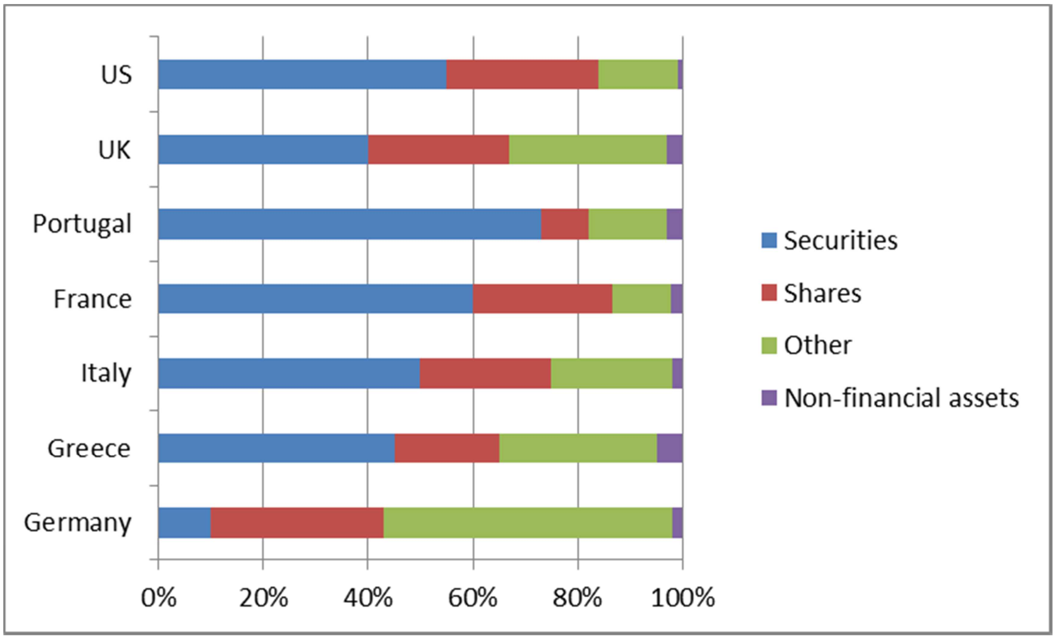
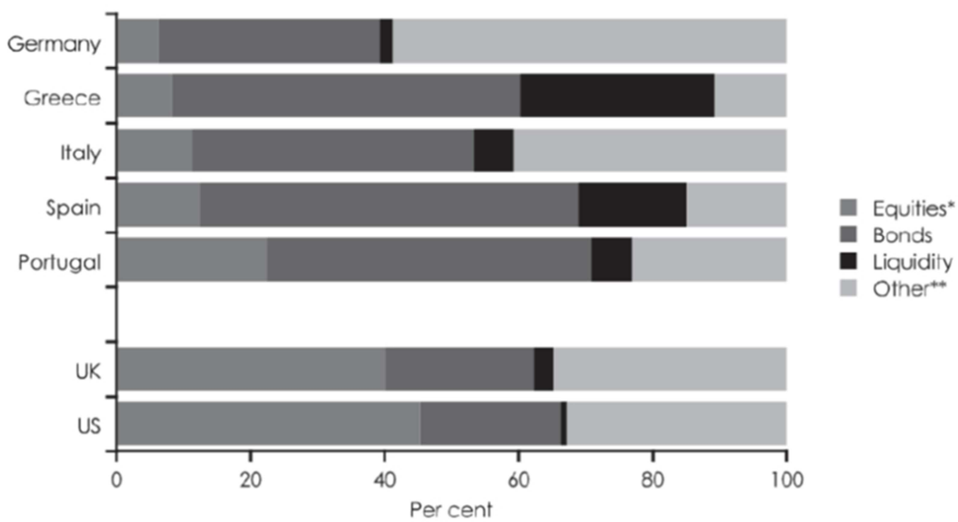
Asset allocation of insurance companies' balance sheets, 2009



Source: OECD

Asset allocation of autonomous pension funds, 2009



* Both direct and through mutual funds.
** Includes loans, land and buildings, unallocated insurance contracts, private investment funds and other investments.

Source: OECD

For asset managers, their ability to invest in long-term assets must fit in with the investment mandate of their clients (unlike banks or insurers they do not have their own balance sheet to use for investment but rather invest clients' assets under management).

It is also important to note that institutional investors require a mix of both long-term and short-term assets to ensure that they can meet both long-term and short-term liabilities (for example, paying out claims for insurers, meeting redemptions for asset managers and as clients draw-down their pensions).

5. The investor

The Green Paper acknowledges that households are the main source of funds to finance investment but that risk aversion is now widespread. 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. We consider that an effective and efficient way to achieve this is for member states to adopt auto-enrolment or mandatory pension schemes. Of course, long term saving is in households' interests as it will help them cope with shocks (such as unemployment), meet medium-term objectives (such as paying for university), and increase their retirement income.

We consider that auto-enrolment or mandatory pension schemes are the most efficient way to raise saving rates. The OECD's Pensions Outlook 2012 notes that some countries have introduced financial incentives to raise pension coverage levels but that "overall enrolment rates are still below those observed in counties with mandatory or quasi-mandatory systems." Moving towards auto enrolled or mandatory pensions schemes would not only address potential pension gaps but will also provide the capital to feed into long-term finance.

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. We support EIOPA's work in reviewing and coordinating financial literacy and education initiatives by competent authorities.

6. The international perspective- barriers for non-EU investors

Non-EU investors will play a vital role in financing Europe's long-term ambitions. The gap left by bank deleveraging may not easily be filled by European insurers or pension funds given that European insurance companies have significantly smaller balance sheets than banks and many member states operate a 'Pay As You Go' pension system so capital may not be readily available for long-term investment. It is therefore essential that Europe maintains its relative competitive advantage over other investment destinations such as Asia, the US and Latin America in order to attract and retain capital from global institutional investors. Some of the largest providers of what could be described as "long term investment" reside outside the borders of the EU – the

Ontario Teacher's Pension Plan and Calpers being two of the most obvious examples. However, these investors can face barriers to investing in the EU.

i. State-sponsored infrastructure procurement

In order to attract non-EU capital to invest, particularly in infrastructure and project finance, non-EU capital must be able to compete on a level playing field with EU funds in state-sponsored procurement processes. The following may help in this regard:

- **US dollar tranches**: Introducing US dollar tranches in debt facilities would boost liquidity by attracting stable and strong US institutional investors. The US private debt market, in particular, has proven its ability to accommodate complex EU infrastructure transactions.
- **Swap breakage**: Non-EU investors can provide Euro funding but they need to protect their currency position. Although that protection does not typically impact EU borrowers, it may provide expensive to unwind in the event of early repayment of a transaction. In such cases; international investors need to be made whole on currency swaps associated with the remaining life of the instrument, through a "Swap breakage" clause.

ii. Regulatory barriers

The Commission should be mindful of the fact that a number of its legislative initiatives may dampen the appetite of such firms to invest in Europe, due to the presence of overly restrictive third-country provisions or extra-territorial reach of a number of key European directives and regulations.

The EU's approach to third-countries in the area of financial regulation appears to be driven by the need to strengthen investor protection in the post-financial crisis economic environment. This understandable yet overly cautious approach to policy making is likely to deter the providers of long-investment from financing a European economic recovery. The Commission should consider reviewing its approach in this area, focusing instead on the objectives and principles of third-country regulatory regimes.

a) Markets in Financial Instruments Directive

The current draft of MiFID 2 would limit investment and funding opportunities by imposing barriers to third country firms providing valuable services. A non-EU firm would be prohibited from providing investment services and activities to clients (other than eligible counterparties) unless they have a branch in the EU. Third-country firms providing cross-border services without a branch will be obliged to register with ESMA, and this authorisation can only be permitted if the regulatory regime of the home jurisdiction of that firm is judged by the Commission to have regulation with equivalent effect to MiFID and CAD requirements, and to provide reciprocal recognition of the EU prudential regulatory framework. The only exception is where the service is provided at the initiative of the EU firm for cross border provision of services (the so-called solicitation test). There is widespread concern that few countries would pass such equivalence and reciprocity tests. Such measures are likely to limit the provision of long-term finance into Europe, rather than enhance it. For example:

- **Risk management**: Asian investors who invest in EU government, bank or corporate bonds may wish to risk-manage their foreign exchange exposure to the Euro or interest rate exposures with OTC derivatives hedges with EU banks. If the EU imposes an equivalence requirement through MiFID it might be impossible, impractical or unattractive for the Asian investor to conclude such transactions on EU venues and it might not be clear if the EU bank was permitted to do that under MiFID/R, pending an equivalence finding. In such circumstances, the attractiveness for the Asian investor to enter into relevant risk management transactions or indeed to invest in EU bonds which originate the exposure might be substantially diminished, affecting the ability of governments and corporates to raise the funding they require to grow their businesses and create jobs.

- **Initial Public Offerings, Mergers, and Acquisitions**: Large EU companies need to access investors worldwide for initial public offerings and debt issuance. They use third country investment banks to manage and advise in key third country markets, whose regulators (for example Hong Kong) may also require the use of a local firm. These third country firms may be providing a service to the EU company. Restricting EU companies' access to them could hinder their ability to source a low cost of capital which in turn could detrimentally affect EU investment, jobs and growth. Similar services are required when EU companies acquire third country listed companies.

b) Alternative Investment Fund Managers Directive

From 2015 onwards, non-EU AIFMs must comply fully with the AIFMD, if they wish to access the marketing passport on offer[10]. The Commission will also review by 2017, whether national private placement regimes should be withdrawn. Under such a scenario, non-EU AIFMs will only be able to market fund interests to EU domiciled investors if the manager is authorised under the AIFMD, regardless of whether the fund is to be marketed in one Member State or several.

Unfortunately, some of the more onerous provisions of the AIFMD – the depositary requirement for example – may deter third-country funds from seeking access to EU markets. This would have a potentially damaging effect on broader economic growth in the region, as private equity funds in particular are well placed to provide the sort of non-bank, long-term finance in demand from businesses and policymakers.

[10] This is dependent upon the Commission taking the view in 2015 that it wishes to make available the Third Country Passport.

The Commission should consider reviewing the requirement for third-country AIFMs wishing to access the marketing passport from being fully compliant with the AIFMD, along with a number of additional requirements[11]. Instead, it should take account of both the principles and policy objectives behind third country regulatory regimes when determining whether to grant access to EU markets, rather than adopting an unduly prescriptive approach in this regard.

7. *Corporate Governance*

The interaction between asset owners and asset managers is key to the promotion of long-term shareholder engagement. The behaviour of asset managers is driven to a significant extent by the demands of their clients and their advisers. For example, the use of benchmarks to measure performance, the review of performance on a quarterly basis and the reporting of performance drivers on a quarterly basis can all reinforce a focus on the short-term.

This, almost continuous, focus on short term movements by asset owners and their advisers leads 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 (IMS). As such, we welcome the Commission's proposed revisions to the Transparency Directive, which would abolish the requirement to publish IMS.

Rather than introducing incentives to encourage long-term engagement e.g. multiple dividends and voting rights, our preference would be 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[12] which is being used in the UK and more widely as a blueprint for improvements. We would propose that legislators and regulators continue to develop such proposed actions in partnership with the industry in order to promote longer term shareholder engagement. A further option to improve accountability could be to make the use of fund managers' voting rights compulsory..

A number of bodies have issued suggested standard templates for mandates. These are often designed to ensure that there are incentives for asset managers to develop long-term strategies and relationships. Examples of this work are the International Corporate Governance Network (ICGN) Model Mandate Initiative and the work being undertaken by Tomorrow's Company to develop guidelines on the relationship between asset owners and asset managers. Encouraging

[11] 1) Cooperation agreements must exist between the Supervisory Authorities of the jurisdiction of the Non-EU AIF and of the Non-EU AIFM and of each EU state where the AIF is to be marketed; 2) The jurisdiction of both the non-EU AIF and the non-EU AIFM may not be on the FATF blacklist and an OECD Model Tax Information Exchange Agreement must be in place between the countries where the AIF and AIFMD are established and the EU country in which the AIFM received authorisation, and all EU states into which it will be marketed; 3) Domestic law surrounding AIFMs must not prevent the relevant EU competent authority from supervising the non-EU AIFM effectively; and 4) The non-EU AIFM must appoint a legal representative in the EU country where it has obtained authorisation.

[12] The Kay review of UK equity markets and long-term decision making: final report (2012) https://www.gov.uk/government/publications/the-kay-review-of-uk-equity-markets-and-long-term-decision-making-final-report

the use of the standards proposed by the ICGN and those to be issued by Tomorrow's Company would improve the support for long-term strategies through mandates and incentives.

The Commission asks whether there is a need to revisit the definition of fiduciary duty in the context of long-term financing. We believe that this would be difficult given the differences in Europe between the common and civil legal systems. As the Commission is no doubt aware, as a result of the comments in the Kay Report on the current legal standard of fiduciary duty, the Law Commission in the UK is currently investigating the duty of financial intermediaries to act in the best interest of beneficiaries when considering an investment strategy, with a final report due to be published in June 2014. We would therefore recommend waiting until the publication of the Law Commission's report before looking at whether any action is needed at a European level.

8. Accounting principles

Listed companies and most large financial institutions in the EU prepare financial statements in accordance with International Financial Reporting Standards (IFRS). IFRS as a framework seeks to report economic performance as it happens – economic performance can be volatile and it is inappropriate to expect an accounting framework to be designed to be capable of smoothing this impact out. Attempts to do so in the past have always involved a loss of transparency through the use of mechanisms such as hidden reserves or general provisions for doubtful loans which can vary from year to year – these do not allow the transparent reporting of results and financial position.

There has been a debate over whether IFRS requirements for fair valuing financial instruments contributed to short-termism. Some argue that recording fair value movements in profit and loss resulted in 'unrealised' profits being recorded and paid out in bonuses and dividends. Others argue that fair value write-downs during the financial crisis created excessive strain on balance sheets leading to distress sales and further write-downs. However, it is the case that fair value write-downs provided early warning signals that led to corrective actions sooner than otherwise would have been the case if such losses had not been recognised.

The use of fair value and different accounting measurement techniques have been carefully reviewed and retuned by the IASB since the crisis and some new or revised standards have been issued, such as IFRS 9 , though not all of these have yet been adopted for use in the EU.

9. Taxation

i. Financial Transaction Tax

We question the coherence of introducing a Financial Transaction Tax with the aims of long-term financing and diversifying the funding sources for corporates. While one of the stated objectives of the tax was to disincentivise short-term trading, the tax will also increase the cost of long-term financing. The impact assessment produced by the European Commission on the FTT shows that such a tax would reduce growth and investment and would increase the cost of capital.

We also believe that the FTT would conflict with the desired aim to diversify the funding sources for corporates so that their reliance on bank funding is reduced. At a time when bank funding is constrained, the main alternative avenue for funding is the financial markets. However, the use of the capital markets, which is already underdeveloped in the EU compared with other economies, will be further disincentivised as these transactions will be subject to FTT, and therefore more expensive, whereas bank loans will not and will therefore be relatively cheaper.

A study conducted by London Economics for the City of London found that on average, corporate bond returns would have to increase by 6-14% (depending on maturity) in order to make up for the cost of the FTT. This increased cost of funding will decrease businesses' ability to invest and grow. Even if the increased costs of accessing financial markets in this way is borne by corporates, for those with group operations seeking to centralise their funding requirements and obligations, yet further FTT may be borne directly on their internal trades due to the wide definition of financial institution and the lack of group exemption.

ii. The treatment of debt vs. equity

In considering what type of CIT reforms could improve investment conditions by removing distortions between debt and equity, we believe that the most important point is not to enact any reforms that could increase the costs of capital for small businesses. This should mean maintaining an evidence-based approach in considering a preference for debt or equity as well as emphasising a 'levelling up' approach when making changes, to make one or the other more competitive. A recent example in the UK was the abolition of stamp duty on AIM shares which will make equity finance more readily available, without increasing the cost of debt finance.

In terms of further specific reforms, the one of most concern would be ending the tax deductibility of debt interest from corporation tax in an attempt to 'equalise' the treatment. This is born from the false assumption that debt finance is somehow unstable and that encouraging its use through the tax system exacerbates this. However there are several reasons why this is not the case and the justification for the existing policy approach is a strong one, largely accepted by the UK Government. We would therefore counsel against other member states departing significantly from this position.

1. Financing costs are as much part of a business' cost base as other revenue expenses, e.g., rent, licence fees, salaries, utilities, etc. If the treatment were removed, significant anomalies could arise in the corporation tax system, e.g., a group that borrowed against real estate assets would obtain no deduction for the interest costs

on those borrowings but a group that entered into a sale and leaseback arrangement to raise capital would obtain deductions for the lease rentals.

2. By changing the treatment of debt, the net cost of borrowing for businesses would be increased at a time when it is already difficult for them to obtain open lines of credit.
3. There are at least eight provisions within the UK tax code that limit the availability of deductions for interest costs on debt. A taxpayer needs to satisfy all of these provisions before an interest deduction is available. These include transfer pricing (quantum and interest rate), the worldwide debt cap, commercial purpose requirements, and distribution rules, anti arbitrage, restrictions on timing of deductions and rules on transactions in securities. Rather than seeking to reform the tax treatment, we would encourage member states to consider strengthening anti-avoidance measures.

It is also important to emphasise that tax is far from the only factor that companies consider in their decision to use debt or equity finance. For example, the legal obligations of a company to its creditors are different to its obligations to shareholders.

Whilst we consider that the UK principle of an arm's length test is the fairest approach, and hence economically justifiable, we note that a number of European jurisdictions (e.g. Germany, France and Spain) have adopted strict debt to equity ratios and caps on interest deductions which, for example, limit deductions for interest costs to a percentage of EBITDA each year. While this has the attraction of simplicity, we would not recommend adopting such an approach because any such limit would always be arbitrary and necessarily fail to recognise that different businesses (e.g. property development, pharmaceutical businesses, infrastructure, retail, etc.) can support different levels and lines of credit, according to their underlying risk profile and cash flows.