

## **Finance Watch response to the European Commission consultation on the long-term financing of the European economy**

**24 June 2013**

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. Its members represent, collectively, many millions of European citizens and include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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For further questions, please contact Frédéric Hache, senior policy analyst at Finance Watch.

## Preliminary remarks

We understand the purpose of this green paper to be the promotion of sustainable growth, innovation and competitiveness through a focus on enhancing the financial system's ability to channel funding to productive use, and we fully support this objective. As this objective and related actions can be understood in different ways, we want to make several remarks:

1. First while we generally support the **scope** considered, we believe that all and not only “many” of the long term investments on which this initiative is focussed should have wider public benefits for society, as we are not convinced about the desirability of giving public support to other types of investments.

The scope is also very heterogeneous and broad. As an example, infrastructure financing and SME financing do not have much in common, requiring very different time horizons and generating very different risks. We could debate whether SME financing should be classified as long term given that the average maturity of SME loans is between five and seven years. Bundling the two in a single initiative is understandable to the extent that both are important for growth and job creation, but risks making related policy actions a heterogeneous catalogue of measures without a clear focus.

2. The trend towards non-bank lending and the related shift in bank business models towards more fee-based activities are not new and existed before the crisis. If we understand the objective of the green paper to be ensuring that the development of non-bank lending and shift in bank business models is appropriately supervised and **leads to a decline in maturity transformation in the system** via a greater role of long term investors, then we welcome it. Alternatively if the objective is merely the promotion of non-bank lending then it raises several concerns in our view.

While alternative sources of funding have undoubtedly a role to play, supervisors must not only facilitate but also monitor and address the threat of build-up of systemic risks<sup>1</sup> linked to this transition, and ensure that it effectively contributes to more long term capital and to a reduction in maturity transformation in the system.

3. Regulators may also question the extent to which this shift is desirable from a society and financial stability point of view and whether it should be promoted. The green paper starts from the assessment that bank long term lending will decline and that we thus need to promote alternative channels of long term financing. We believe however

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<sup>1</sup>Standard & Poors - out of the shadows: the rise of alternative financing in infrastructure.

that **bank lending should not be so easily dismissed**, that it does not have to decline much and that regulators should work in parallel to reinforce banks' lending ability.

There is indeed a **qualitative difference between bank lending and non-bank lending**, in terms of flexibility for the borrower (revolving stand-up features of bank loans, flexibility to negotiate revised terms and conditions) and in terms of quality of the risk assessment especially for SMEs: banks are far better positioned due to their lasting global relationships to integrate qualitative elements in their risk assessment with a positive impact on reducing procyclicality.

Additionally, it is important to bear in mind that **banks<sup>2</sup> and capital markets are inextricably linked**, as bank activities are at the heart of capital markets, from issuance, underwriting, marketing of clients' signatures and other activities. Well-functioning capital markets require well-functioning and trusted banks. A dysfunctional banking system and a lack of trust in bank solvency impacts negatively on all financial channels and leads to higher risk premiums.<sup>3</sup> As an example, recent studies concluded that *"SME securitization can only work when there is confidence in the banking system"*<sup>4</sup> and that when interbank lending freezes up securities market activities become more difficult and the cost of capital rises.<sup>5</sup> It is therefore fundamental to restore confidence in banks in order to strengthen both bank lending and alternative sources of financing.

In this respect there is an urgent need to revisit Basel 3: there is already some evidence that markets do not trust Tier 1 capital as a measure of risk and prefer instead the leverage ratio and that bank leverage hasn't been restrained. Studies have found also that Tier 1 capital has no predictive value of banks distance to default unlike the leverage ratio,<sup>6</sup> whereas banks' vulnerability to default has been identified<sup>7</sup> as a direct impediment to lending and long term investment.

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<sup>2</sup> We refer here specifically to investment banking activities

<sup>3</sup> OECD - the role of banks, equity markets and institutional investors in long term financing for growth and development. <http://www.oecd.org/finance/private-pensions/G20reportLTFinancingForGrowthRussianPresidency2013.pdf>

<sup>4</sup> OECD journal - bank deleveraging, the move from bank to market-based financing, and SME financing. [http://www.oecd.org/finance/financial-markets/Bank\\_deleveraging-Wehinger.pdf](http://www.oecd.org/finance/financial-markets/Bank_deleveraging-Wehinger.pdf)

<sup>5</sup> OECD - the role of banks, equity markets and institutional investors in long term financing for growth and development.

<sup>6</sup> OECD journal - business model of banks, leverage and the distance to default. <http://www.oecd.org/finance/BanksBusinessModels.pdf>

<sup>7</sup> OECD - the role of banks, equity markets and institutional investors in long term financing for growth and development. <http://www.oecd.org/finance/private-pensions/G20reportLTFinancingForGrowthRussianPresidency2013.pdf>

The recent comment from Thomas Hoenig, vice chairman of the FDIC, that *“the Basel III accords allow lenders to appear well-capitalized when they are not”*<sup>8</sup> is only one of several similar assessments.

The **necessary decline in bank lending as a result of bank deleveraging is also very limited**: EU banks' loans to non-financial corporates and households currently represent only 28% of their total assets<sup>9</sup> leaving significant other assets from which deleveraging can occur. The IMF estimates necessary deleveraging for European banks at 7% of their assets, with only a quarter of that coming from lower lending and the rest from asset sales or profit retention.<sup>10</sup> If banks' managements choose to reduce lending instead of getting rid of bad assets it is thus only a management decision, which strengthens the case to supervise deleveraging more tightly. We also need to keep in mind that stronger, better capitalised banks will also be more likely to pursue growth lending strategies.<sup>11</sup> Lastly, as regulation played a significant role in the development of non-bank lending, it can and should play a role in reversing this trend to finally build robust banks better able to lend and restore trust in banks with related benefits for all stakeholders.

4. The current shift in bank business models also raises the question of whether we are encouraging a **more fragile, interconnected and procyclical bank model**. The most affected banks during the crisis were indeed those whose model was geared towards securities, derivatives and structured products<sup>12</sup>.

Just as capital markets don't necessarily distribute risk and increase stability, banks focussed on securities and derivatives are more vulnerable to procyclical margin and collateral calls with an adverse impact on their ability to provide stable financing. Given the capital markets inclination towards irrational exuberance, the move of business models further away from lending and trust relationships, and towards trading

<sup>8</sup> <http://www.reuters.com/article/2013/06/14/us-financial-regulation-deutsche-idUSBRE95D0X620130614>

<sup>9</sup> According to the High Level Expert Group on reforming the structure of the EU banking sector

<sup>10</sup> quoted in OECD journal - bank deleveraging, the move from bank to market-based financing, and SME financing

<sup>11</sup> "Supervisory policies and bank deleveraging: a European perspective" Andrea Enria - 21st Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies Debt, Deficits and Financial Instability 11th April 2012

See also Mervyn King "Those who argue that requiring higher levels of capital will necessarily restrict lending are wrong. It is insufficient capital that restricts lending."

Farewell speech as Governor of Bank of England, 19 June 2013

<http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech670.pdf>

<sup>12</sup> OECD – The role of banks, equity markets and institutional investors in long-term financing for growth and development

and price discovery as identified by the European Commission, may have endangered the fundamentals of sound banking.<sup>13</sup>

5. In the case of infrastructure financing, it would be also worth debating the **key question of whether the financing of projects with positive externalities and public benefits should be privately funded**. Even though the current context of strained public finances does not provide much margin in the short term, this will not always be the case and given the long term horizon of these projects we believe that the question is worth asking. Private ownership of public goods and public-private partnerships have sometimes failed spectacularly to deliver the right outcomes for society. It is therefore fundamental to ensure a fair sharing of risks and returns for all stakeholders. It would be also worth considering on what terms and in which circumstances it would make sense to transfer public good assets to public ownership in the event that private ownership fails to deliver value for money services.

6. If capital markets are to play a bigger role in the long term financing of the economy **they need to fundamentally evolve** from the current beauty contest where investors vote not the prettiest person, but the person that they believe the majority will find the prettiest, to borrow Keynes's famous analogy. In other terms they need to evolve from a culture of trading based on asset prices movements where assets are bought even though their price doesn't make sense, as long as others are expected to carry on buying them, to a culture of investment based on the assessment of the intrinsic value of companies and projects.

Bearing in mind all these remarks, we agree that a limited development of non-banking lending if properly supervised can provide a welcome additional funding source. As regulators need to monitor this shift in order to ensure that it delivers the right outcomes for all stakeholders, we strongly welcome this consultation.

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

We do agree with the analysis regarding the supply and characteristics of long term financing.

Given the key role of financial advice on households' investment decisions and the discretionary asset allocation power of some non-bank lenders, we would also consider banks and non-bank lenders to be more than mere channels, as their asset allocation

<sup>13</sup> OECD - the role of banks, equity markets and institutional investors in long term financing for growth and development.

choices incorporate not only end investors / households' preferences but also their own assessments and preferences that may differ.

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

We like the European Commission's definition and find it superior to alternative definitions based on a specific maturity threshold.

On the nature of the asset classes appropriate for long term investment, we would be inclined to be more specific for the purpose of this initiative and add the three following criteria:

- Investments in sectors with long term business cycles or requiring large upfront costs and long horizons before they break even or can be sold at a fair price.
- Investments providing public benefits or positive externalities for society, such as infrastructure, hospitals, universities, energy transition and direct venture capital that finances innovation.
- Investments where there is an identified current or expected funding gap.

Lastly, on the nature of the financial intermediation involved, while we agree that long term financing may require significant maturity transformation, we would again for the purpose of this initiative add that financial intermediation should aim as much as possible at matching long term funding needs with long term resources with a view to reducing maturity transformation in the system.

***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?***

As stated in the green paper, bank lending will remain the main source of financing in the European Union and while alternative sources of financing are developing, any change is likely to be gradual.

The evolution of the banking sector will likely mean an increase in fee based activities linked to capital markets, from bond issuance, underwriting, marketing of clients' signatures to securitisation, as banks are at the heart of financial markets. The related risks in terms of fragility of the business model, increased interconnectedness and other systemic risks should be monitored appropriately to ensure the stability and sustainability of both banks and capital market financing.

Banks may also develop their role managing specific risks and financing specific horizons of project finance where there is little institutional investor appetite, such as

construction risk in infrastructure projects. This growing role makes it important that incentives are aligned: typically the bundling of construction, operation and maintenance in project financing schemes seems to provide the right incentives and should not be weakened by new risk / funding sharing agreements.

Lending will and should remain a key activity of banks, not incompatible with the development of alternative channels.

Corporations and SMEs in particular favour bank lending over other sources of financing for several reasons: it provides more flexibility to revise loan terms and conditions and repay early, whereas it is harder to negotiate with numerous bond investors who do not necessarily have the process or appetite to handle contingencies. In fact when choosing a type of lender, price is not always the first factor and sometimes comes after availability, reliability and the terms of lending.<sup>14</sup>

Bond investors are also not set up to maintain relationships with borrowers, and non-bank lenders also sometimes struggle to accommodate the revolving/stand by features of most bank loans.

Additionally banks' global, lasting and *intuitu personae* relationships with their clients enable them to know much more about borrowers' businesses than non-bank lenders, as they handle payments, current accounts and often know entrepreneurs themselves via their branches. Banks can thus more easily incorporate critical qualitative elements in their risk assessments such as the quality of the management, while ratings and scoring methodologies more prevalent in capital market financing are more based on quantitative elements. This qualitative dimension is not only key for the quality of the risk assessment, but it also provides a precious countercyclical element.

Lastly, because bank lending is conducted by one entity as opposed to the many entities involved in non-banking credit intermediation chains, bank lending also creates less interconnectedness.

As stated earlier, the decline in bank lending as a result of deleveraging could be very limited, as the necessary deleveraging involves getting rid of bad assets rather than reducing lending. Once deleveraging is completed, banks' lending capacities will increase, as robust well capitalised banks can lend more.

In this respect confidence in banks' solvency has not been restored, Basel 3 Tier 1 capital has been shown by several studies to have a weak connection with banks' distance to default and leverage has not been restrained due to the distortions in risk weighting. Given the pivotal role of banks in the financial system, there is an urgent need to ensure that banks are well-capitalised in order to foster long term financing. When the

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<sup>14</sup> The Association of Corporate Treasurers – Comments in response to Discussion paper on non-bank lending. Feb 2010

Commission assesses rightly that the repricing of risk after the crisis will raise the cost of capital, this rise would be greatly reduced if concerns about bank solvency disappeared. We therefore believe that for all the reasons mentioned above, the European Commission should seek, in parallel with its action on non-bank lending, to further restore bank solvency and ensure that bank lending does not decline significantly.

***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?***

National and multilateral development banks have a clear role to play in cases where long term investments with positive externalities are not met with an adequate supply of funding, and where social returns are superior to private returns.

We fully support the role envisaged in the green paper, from guaranteeing first losses or funding the early stages of projects, to providing guarantees for specific risks where private actors lack expertise or appetite.

It is fundamental as well to ensure clear and transparent procedures for intervention, accountability through clear financial and non-financial performance benchmarks and a fair sharing of risks and returns with private actors.

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

We believe that three other types of public policy tools can support the financing of long term investments:

- Building a pipeline of well-structured infrastructure projects where private interest is not meeting needs: A clear and consistent public strategy on project finance would help to create a pool of assets for long term investors. It should be supported by a clear framework for intervention and accountability, and deals structured to take into account the constraints and appetite of these target investors.
- Encouraging the collection and sharing of data and track records on infrastructure financing, as there is a need to educate investors about this new asset class.
- Promoting investors education in order to address behavioural biases against long term investing (our natural tendency to prefer short term over long term decisions, our



preference for immediate returns over delayed ones, and our tendencies to overweight short term information and to cut losses early), addressing the sometimes excessive focus on liquidity, and change investment beliefs that get in the way of real value investing. Such action should be targeted not only at end investors but also across the intermediation chain, from financial advisors to consultants and pension trustees.

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

Institutional investors are already playing a growing role in long term financing, from corporate lending to infrastructure funding, with global asset managers such as Blackrock or Allianz setting up large infrastructure debt funds and insurers looking to increase their exposure to infrastructure.

Within institutional investors we believe that it would be useful to distinguish between long term and non-long term institutional investors, and between activities that have long term liabilities and enable long term investments without maturity transformation and other activities.

Apart from the provision of alternative - if not independent - sources of funding, the key benefit of a growing role of institutional investors is indeed the related reduction in maturity transformation and increased availability of non procyclical funding in the financial system.

For instance, guaranteed euro funds in life insurance provide a more appropriate time horizon for the purpose of long term financing than unit-linked insurance or equivalent short term funds.

In addition to the regulatory, taxation, accounting, governance and metrics dimensions that will be covered in other questions, we believe that two additional dimensions could enable institutional investors to play a greater role in this changing landscape:

- The building of expertise on project finance and loans features: while institutional investors are already involved in infrastructure financing and plan to increase the share of this asset class in their asset allocation, they often do so via infrastructure funds or by investing in utilities, and many of them do not have yet the in house expertise required to assess the related risks. Developing such an expertise would enable them to increase further their involvement and move towards more innovative projects.

Similarly, deepening their understanding of corporate borrowers' needs might enable them to accommodate more easily loan features that they are not familiar with, with a positive impact on their ability to serve this category of borrowers.

- A lack of appropriate financing vehicles and debt instruments has been identified as a barrier to investment<sup>15</sup> as only the largest investors have the capacity to invest directly in infrastructure projects, and issues of excessive fees and leverage have arisen with some existing collective investment schemes. The development of instruments such as inflation linked infrastructure bonds with fixed returns and some insurance guarantees, and more generally the issuance of more instruments matching the liability profile of long term investors and providing the risk/return profile that they want would contribute positively. In this respect the European project bond initiative is a very useful and welcome development.

***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?***

We fully agree with the European Commission's assessment of the root causes of the equity gap in Europe, which include ageing populations, a shift of pension funds towards defined contributions, stock exchange business models, the preferential tax treatment of debt over equity, changes in regulatory incentives and the growth of alternative investments.

Some elements are temporary: the weak economic outlook discourages instruments with an unlimited return potential such as equities and encourages a flight to quality towards sovereign bonds. Other elements are structural and require some key changes.

Equity instruments have many potential benefits and if used properly can promote accountability, a sense of ownership and lower leverage while providing unlimited upside to investors. As they are perpetual instruments, they are a very good tool for companies to make long term decisions, provided that shareholders take a long term view of the company.

Thus we support the proposals made in the green paper such as removing the tax bias favouring debt over equity and addressing suboptimal market behaviour.

In particular the focus on maximising short term shareholder value and the dictatorship of smooth earnings are linked to a short-sighted and limited conception of risk and

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<sup>15</sup> OECD - the role of banks, equity markets and institutional investors in long-term financing for growth and development  
<http://www.oecd.org/finance/private-pensions/G20reportLTFinancingForGrowthRussianPresidency2013.pdf>

should be addressed. Incidentally, a survey of corporate executives found that 78% of them would give up economic value in exchange for smooth earnings.<sup>16</sup> Something is deeply wrong with capital markets when companies are willing to trade-off economic value against earnings matching analysts' forecasts and a lower volatility of their stock price.

This comes from a conception of risk that doesn't differentiate adequately between volatility of earnings linked to the normal course of business and risk coming from structurally declining earnings,<sup>17</sup> that also doesn't differentiate adequately between volatility of stock prices and "failure of investments to meet the reasonable expectations of savers", and that focuses more on relative performance to a short term benchmark and less on fundamental value.

The large growth in financial intermediation and poor alignment of incentives also compounds the problem.

Addressing these issues requires taking action on several fronts, including governance arrangements, regulatory incentives, a rethinking of the interpretation of the fiduciary duty and tax incentives.

Governance changes include new asset allocation frameworks for institutional investors more focussed on the fundamental drivers of risk and return,<sup>18</sup> corporate executives' compensation arrangements that incentivize horizons longer than their (sometimes short) employment, increasing corporate boards' sense of ownership, reducing financial advisors' incentive to promote instruments with a high turn-over potential.

Improving companies' disclosure of non-financial information and ability to communicate about their story would also help, as well as educating investors about the implicit trade-off between liquidity and return, a message that should be more audible in the current context of very low real interest rates.

Regulation has a key role to play by differentiating adequately between buy and hold investments and trading, and between risk and volatility of asset prices. It should also take action to simplify financial intermediation chains and further align interests between intermediaries, borrowers and lenders.

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<sup>16</sup> Graham, Harvey and Rajgopal (2005)

<sup>17</sup> Kay review "If the market prices of assets represent partly or wholly the beliefs of market participants about what other market participants do or will believe and if these market participants have little or no knowledge of the capacity of these assets to generate earnings or cash flow, then 'marking to market' conveys little or no information relevant to long-term decision making by companies or by asset managers, and gives little indication of the long-term value generated for savers." "Risk in the equity investment chain is the failure of companies to meet the reasonable expectations of their stakeholders or the failure of investments to meet the reasonable expectations of savers."

<sup>18</sup> World Economic Forum - the future of long term investing.

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

While covered bonds have proven fairly resilient during the crisis and while they are less vulnerable to principal-agent problems than securitisation, they provide limited benefits due to their impact on asset encumbrance.

More fundamentally, while we recognize the benefits provided by collateralised funding when there is a crisis of confidence, we would find it **very unhealthy to promote a normalised use of collateralised funding at all times, as it is important to remember that finance, capital markets and lending are about trust, and validating instruments based on absence of trust would be a very dangerous development** with important unintended consequences going beyond the current decline of unsecured funding. It would be far healthier to act more decisively on restoring confidence and a lot is yet to be done in that area.

As an example of possible actions, the crisis has evidenced the damage that can be inflicted by solvency concerns on financial institutions. Solvency concerns can be based on actual solvency issues but also on investors' perception of solvency issues, which can sometimes be excessive or irrational. While the former can be addressed through higher capital requirements, addressing perception is more difficult and requires improved transparency, accountability and credibility of solvency measures.

In this respect, the recent CRD IV/CRR package will have a modest positive impact on solvency but unfortunately a very weak impact on perceptions: while banks' regulatory capital will increase, leverage will still remain unconstrained, and the transparency of banks' regulatory capital and solvency will not improve.

Therefore while we recognize the benefits of covered bonds, we are not convinced that promoting this instrument via a harmonization of the European framework is a promising direction.

**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?**

Despite having been at the heart of the 2007 crisis, securitisation is not a bad tool per se, and, if done properly, can provide a useful alternative source of funding. Therefore the answer to the question of whether it is desirable to revive the securitisation market in the EU has to be nuanced, as the devil is in the details.

As an example, the decline of securitisation done for regulatory arbitrage purposes or without effective transfer of risk is a good thing and should not be revived. The higher systemic risks linked to interconnectedness posed by securitisation compared to bank lending must also be compensated by bringing strong benefits if the practice is to be positive for all stakeholders.

We are also not sure how to interpret the stated objective to balance financial stability and the need to improve maturity transformation by the financial system, as we do not view these goals as contradictory: indeed improving maturity transformation is good for financial stability.

If the question implies shifting maturity transformation from banks to securitisation, then we find it important to remember that maturity transformation poses equivalent risks in banks and non-banks. If however the question implies a need to develop a form of securitisation with very limited maturity transformation through issuing long term securities sold to long term investors, then agreeing with former chairman of the Financial Services Authority Adair Turner<sup>19</sup> we fully support such an evolution.

There are numerous problematic issues with securitisation that need to be addressed, including flawed or inexistent credit risk transfer, principal-agent problems all along the chain, asset encumbrance, lower flexibility for borrowers, excessive reliance on ratings, increased interconnectedness, unrestrained leverage, risk assessments that overweight quantitative elements and bank support over the quality of the underlying asset pool, and asymmetry of information compounded by a lack of transparency about the underlying assets.

Amongst these, the quality of the underlying pool of assets is one of the key elements: while securitisations with sound assets have usually done well through testing times, the decline in the quality of the pools and securitisation of non-typical assets pre crisis was a major factor in the problems that ensued. Securitisation is especially vulnerable to these risks since this technique enables almost any asset to be made to look attractive and safe.

In this respect industry initiatives such as quality labels<sup>20</sup> are a step in the right direction. In particular, transparency and simplicity standards providing investors with more detailed data at loan level and cash flow models, and requiring the disclosure of credit enhancement mechanisms are very good proposals. They should enable investors to

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<sup>19</sup> "Securitisation might be a good thing, but not in its pre-crisis shadow banking form. That it would be desirable if we saw the further development of the credit intermediation channel which connects non-leveraged long-term investors to long-term borrowers." Shadow banking and financial instability - Adair Turner (March 2012)

<sup>20</sup> Prime Collateralised Securities rule book

make better risk assessments, reduce reliance on external ratings and incentivize sound underlying assets.

We also welcome quality standards that exclude resecuritisations and synthetic securitisations while including independent third party reviews of the originator's general portfolio from which the underlying assets were selected.

We believe nevertheless that some additional dimensions are necessary in some of the quality labels frameworks in order to address all the issues above:

- For the purpose of this initiative, the list of **eligible assets** that should be promoted in "good" securitisations should focus on long term productive investments where there is an identified shortage of funding. In this respect, quality labels' eligible assets seem to focus instead on non-productive assets with the exception of SME loans, and do not include long term productive assets such as infrastructure. Instead they include non-productive assets that are prone to bubbles and where there is no shortage of funding, such as residential mortgages. While we appreciate that such labels were not created to promote long term financing and that non-productive assets may benefit from a sound framework in their own right, this raises the question of whether regulators should include such labels in the regulatory response to the long term funding gap.

- Such labels do not seem to include any criteria on **maturity transformation**, whereas as stated earlier one of the main objectives of developing non-bank lending should be to reduce maturity transformation in the system. Again this is not a criticism of quality labels, just a comment on their relevance for the purpose of long term financing.

- While we fully support and welcome proposals aimed at ensuring that securitised assets are not of a lower quality than comparable assets retained by the originator, we wonder whether the core importance of this point does not require **stronger incentives** than obtaining a label: as an example, terms providing for the financial compensation of investors should the average quality of securitised assets be materially different from comparable assets retained may need to be investigated.

Additional lending rules including qualitative elements should also be used, especially for SMEs, to ensure the homogeneous quality of the loans, and should be disclosed to investors.

- As **rating agency methodologies** are currently too focused on whether the underlying asset pool benefits from a full or partial support,<sup>21</sup> and not enough on the quality of the underlying pool, it would be beneficial to require CRAs also to provide ratings that do not take into consideration possible support. We believe as well that CRAs should not be

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<sup>21</sup> From monoline insurers or other types of institutions

allowed to collaborate with issuers to help them get the best ratings, as such collaboration magnifies the impact of model flaws.

- Integrating **more flexibility** for borrowers in quality labels regarding the possibility to revise terms and conditions or repay early could also be useful, as borrowers' reluctance to see their loans securitised comes partly from the relative inflexibility of the terms and conditions of this instrument. If securitisation is to take a bigger role compared to bank financing, it should be ensured that it meet borrowers' needs better.

- On **transparency**, additional measures could be investigated such as disclosing separately data on different types of underlyings, in the case of conduits bundling together very different types of assets.

Interesting proposals have also been made by IOSCO and the OECD<sup>22</sup> and should be part of any future framework, such as requiring access to loan level data for investors identical to that of CRAs, providing scenario analyses and average expected loss coverage structuring assumptions, introducing investor suitability requirements, and promoting products with limited tranching.

Lastly, as recognized by the IOSCO Task Force on Unregulated Financial Markets and Products, industry initiatives have limits, since participation is voluntary and neither industry initiatives nor market discipline prevented the current crisis.<sup>23</sup>

There is a need for regulators to monitor and restrain the possible related systemic risks such as leverage, interconnectedness and the build-up of unrealistic assumptions in the system, since non-bank lending is not subject to the same capital, leverage and transparency requirements as banks. While we are not advocating an overly complex and discretionary regulation similar to banks, we believe that a two-tier system of regulation may create the wrong incentives, and that at the very least equivalent restraint on leverage is required.

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

Addressing the tax distortion between debt and equity is long overdue and we strongly support the European Commission's willingness to embrace this issue.

An IMF staff discussion note<sup>24</sup> analysed two alternatives to current tax codes. The first

<sup>22</sup> IOSCO Task Force on Unregulated Financial Markets and Products implementation report FR04/11 - March 2011

OECD: bank deleveraging, the move from bank to market-based financing, and SME financing [http://www.oecd.org/finance/financial-markets/Bank\\_deleveraging-Wehinger.pdf](http://www.oecd.org/finance/financial-markets/Bank_deleveraging-Wehinger.pdf)

<sup>23</sup> IOSCO TFUMP Final report September 2009



one would eliminate the deductibility of interest for corporation tax purposes. A number of countries have already opted to reduce interest deductibility, but such reductions do not eliminate the debt bias and create new opportunities for tax avoidance. No country as of yet has opted for the full elimination of the debt bias for fear of increasing the cost of capital. But whilst it is true that in itself elimination of the subsidy would increase the cost of capital, it would also broaden the tax base and, as a consequence, allow a reduction in the corporate income tax rate that could compensate for the subsidy loss and reduce the tax burden on profitable equity financed investments.

A second alternative would be to introduce an allowance for corporate equity, i.e. a deduction from the tax base of the notional return on equity. Apart from eliminating the debt bias, such an allowance would also promote increased investment and higher economic growth. The cost to public revenues might be an obstacle, however it could be reduced in the short term by giving the allowance only to new investments. In the long term the expected costs should be limited as the favourable economic effects would broaden the tax base.

***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?***

Tax incentives should be used as stated to correct externalities from market failures and promote productive investments whose social returns are superior to their private returns, creating a funding gap.

As discussed in the European Commission staff working document, tax incentives may not necessarily generate additional savings and rather divert existing savings, but given the high level of European savings, succeeding in diverting existing savings towards long term investments would already be a great achievement.

Specifically we would favour the introduction of capital gains tax rates in proportion to holding periods, using several thresholds. Such a tool would be very useful to incentivize investors to take longer, more fundamental views of the companies they invest in. Existing tax incentives could also be more targeted. For example, tax incentives favouring life insurance in France do not distinguish adequately between unit-linked contracts and guaranteed euro funds, whereas only the latter provide capital for long term investing.

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<sup>24</sup> IMF 'Tax biases to debt finance: assessing the problem, finding solutions' (2011)



A review of inheritance taxes to favour investments in long term productive assets with clear positive externalities could also be worth considering.

Lowering the tax rate of capital income compared to other incomes would however be a dangerous direction as it would fail to recognize that long term growth requires not only savings but strong consumption and a robust social contract.

Given the currently strained public finances, we are aware that reducing tax collection is a very sensitive issue. Such revisions could, therefore, be financed by reducing existing tax incentives targeted at non-productive investments prone to bubbles, such as real estate if need be.

***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?***

While the use of fair value accounting principles can provide some benefits, such as limiting companies' ability to manipulate their net earnings, studies have found that the choice of accounting standards may influence the behaviour<sup>25</sup> of many stakeholders, including financial, non-financial institutions and investors. For the purposes of this question we will focus our answer on investors.

- Fair value accounting increases the focus on changes in asset prices and compounds the problem by exacerbating procyclicality.<sup>26</sup> It also creates related concerns that institutions will shorten the duration of their assets in an attempt to minimize volatility in their reported earnings.
- Even though the classification of assets by intended holding period provides some protection and the possibility to shift assets from level 1 to levels 2 and 3 provides an element of insulation against liquidity shocks, the reliability and credibility of this approach is questionable when secondary markets do not function, with a related impact on investor confidence.
- More fundamentally and agreeing with the Kay review of UK equity markets and long-term decision making, we may question the relevance of the information provided by

<sup>25</sup> Fair Value Accounting, Disclosure and Financial Stability: Does How We Keep Score Influence How the Game is Played? By Richard J. Herring Jacob Safra Professor of International Banking The Wharton School, University of Pennsylvania. <http://fic.wharton.upenn.edu/fic/papers/11/11-72.pdf>

<sup>26</sup> Even though it is important to distinguish between marked-to-market valuations in private contracts and fair value accounting, and to remember that other factors played a bigger role, such as the short term funding of highly leveraged long term illiquid assets, fair value accounting played a role in reinforcing downward price spirals transmitted directly to other institutions holding similar assets.

fair value accounting: *“mark to market accounting relies to a substantial extent on the belief that market prices have the informational content”. However “if the market prices of assets represent partly or wholly the beliefs of market participants about what other market participants do or will believe and if these market participants have little or no knowledge of the capacity of these assets to generate earnings or cash flows, then ‘marking to market’ conveys little or no information relevant to long-term decision making by companies or by asset managers, and gives little indication of the long-term value generated for savers. (...) The priority given to regular price information focuses attention on market fluctuations at the expense of fundamental value and creates biases in the investment decisions of both companies and savers.”*

There is no easy solution to address these concerns; several proposals have been formulated that deserve further investigation, from disclosing together the fair value and amortized cost value of assets available for sale or held for trading, to reassessing the conditions of use of fair value and shift from level 1 to levels 2 or 3. More importantly, this strengthens the case for the increased integration of financial and non-financial information as per question 24 to incentivize investors to take a long term view of the companies they invest in.

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

Several types of incentives would help promote better long-term shareholder engagement:

- Making the exercise of ownership rights part of the mandate of investment managers. Related additional measures such as requiring institutions to explain why they don't provide active oversight could also be considered.
- Companies could improve the sense of ownership of retail shareholders by communicating more on their core business so that investors buy the long term story and not only the potential for a quick gain. They could also communicate on the fact that holding management accountable via minority shareholder groups is a more constructive alternative to selling your shares.
- Possible additional measures include attributing additional dividends to shareholders voting at general assemblies. Companies' frequent reluctance to see more shareholder engagement should be balanced against the likelihood of increased loyalty from shareholders.

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

Governance arrangements are a key factor for shifting asset managers' interests and actions towards longer term investment strategies and comprise several dimensions.

Rethinking beliefs about long term investing and approach to risk appetite: Asset managers need to believe that they can generate higher returns by investing long term for them to do so.

As the crisis raised several questions regarding investment assumptions - such as the role and effectiveness of portfolio diversification in an interconnected world, the performance of buy and hold strategies compared to short term trading, the attractiveness of the liquidity premium of illiquid assets compared to their risk<sup>27</sup> - it provides an excellent opportunity to reassess core beliefs.

Asset managers' beliefs come from their education and their professional experience and neither is neutral: a large proportion of fund managers had a similar education promoting modern portfolio theory and efficient market hypothesis, and their professional experience is also biased by self-fulfilling beliefs caused by herding behaviour and relative performance benchmarking. Taking the time to question these beliefs and formulate clear new ones should therefore be encouraged by management.

Using performance metrics that track long term performance: several good proposals already exist,<sup>28</sup> including assessing at different points in time whether the original assumptions and cash flow forecasts still hold, looking at changes in income or dividends in addition to changes in asset prices, looking at absolute return targets rather than relative to short term benchmarks, shifting to moving average investment targets over the maturity of the investment and monitoring the investment turnover ratio of fund managers.

For these metrics to be effective, additional elements are required such as clear individual accountability, choosing a limited number of metrics that provide the information deemed necessary, and adopting a critical perspective as no metric is perfect. Asset managers must also believe that their management will assess their performance using these metrics, and investors and boards must be educated about these new metrics.

Incentivising a long term approach via adequate compensation arrangements, team stability and reduced externalisation: compensation structures must have the proper

<sup>27</sup> World Economic Forum : the future of long term investing

<sup>28</sup> World Economic Forum : the future of long-term investing

horizon and adequate incentives such as bonus clawbacks or bonuses placed in parallel portfolios invested alongside the fund, and additional stock compensation for management that cannot be sold until retirement to ensure that the horizon of strategic decisions goes beyond managers' current employment.

Promoting team stability through providing job satisfaction, a sense of mission and of being part of a community is as important as monetary incentives to promote a long term perspective instead of a short term oriented mercenary culture.

Additionally the increasing reliance on external asset managers and consultants has been found to increase the risk of misaligned incentives. Encouraging a shift towards in-house fund managers through the build-up of the necessary expertise would help to align incentives over the right horizon.

Decision making structures have also been identified as a constraint on the ability of investment teams and trustees to implement long term investment strategies when they are not clear or aligned. An official commitment throughout the organisation, professional boards and clear negotiated mandates can contribute positively and strengthen asset managers' beliefs that their management will maintain the strategy in difficult times.

The recent shift in asset allocation frameworks towards a greater focus on the key drivers of risk and return and relying less on potential diversification benefits between asset classes should be encouraged. Examples include simplified frameworks focused on allocation between risk factors rather than asset classes (equity, liquidity, term, credit), macroeconomic allocation (which type of investment depending on the macroeconomic outlook) or thematic allocation (which long term trend to invest in: renewable energy, ageing populations).<sup>29</sup> New mandates should also provide more flexibility with regards to rating and focus instead on internal risk assessments.

Regulation has a key role to play to promote these changes in governance, by supervising and ensuring that funds' compensation structures and performance metrics match their stated horizon. Mismatches may also be addressed via a revised interpretation of fiduciary duty.

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

We believe that there is a need to clarify the application of the concept of fiduciary duty to investment matters.

<sup>29</sup> World Economic Forum : the future of long-term investing

Current regulatory obligations in the investment chain are weaker than the standards of fiduciary duty, and there is currently no consensus on whether asset managers' duties to their investors have a fiduciary nature.

We strongly believe however, agreeing with the Kay review,<sup>30</sup> that there is no sound basis for *"placing trust in an intermediary who does not recognise these duties"*, and that *"Whatever the current legal position governing particular relationships in the equity investment chain, effective stewardship is possible only if trust, confidence and respect are established and the steward proceeds on the basis of obligations of loyalty and prudence."*

It is important to remember that finance is about trust. The distrust of the financial industry following the crisis is evidence that current regulatory obligations and relationships governed by contracts failed to ensure that the client's interest are always put first.

As important in the context of long term financing, fiduciary duty requires the agent to focus on the long term welfare of the client, and as argued by ShareAction,<sup>31</sup> we believe that it is very different from the narrow interpretation of some trustees focussing on maximising short term returns.

We therefore agree with the Kay review recommendations and believe that all participants in the investment chain should observe fiduciary standards in their relationships with their clients.

We are convinced as well that there is a need to review the legal concept of fiduciary duty to clarify how it should be applied to investment.

***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?***

Assessing the long term performance of a company requires a deep understanding of its business, strategy and a good knowledge of the quality of its management. This requires both financial information and non-financial information: the analysis of the balance-sheet, EBITDA and cash flows is not sufficient to provide a complete picture and assess risks and future performance.

Non-financial information includes the qualitative elements that foster taking a long term view of the company and encourage countercyclical financing. It also provides

<sup>30</sup> The Kay review of UK equity markets and long-term decision making – final report

<sup>31</sup> ShareAction / Fair Pensions: Kay review call for evidence: response from fair pensions  
[http://www.fairpensions.org.uk/sites/default/files/uploaded\\_files/KayEvidence\\_Nov2011.pdf](http://www.fairpensions.org.uk/sites/default/files/uploaded_files/KayEvidence_Nov2011.pdf)

essential information about the sustainability dimension of the company, and we strongly support the Commission's work on developing a more robust non-financial reporting framework.

We also agree that the obligation for quarterly reporting should be lifted, as its perverse effects clearly outweigh any benefits: quarterly reporting creates unnecessary additional volatility by triggering short term trading when it is released. More importantly it strengthens CEO's and CFO's obsession with earnings and short term stock market fluctuations; the excessive focus on quarterly earnings consumes undesirable amounts of energy from management and incentivises an overweighting of short term decisions aimed at pleasing financial analysts to the detriment of a strategy aimed at building the long term economic value of the company.

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

Inadequate metrics have been identified as one of the constraints weighing on long term investment: just as risk is not the volatility of past earnings but rather the failure of an investment to meet the reasonable cash flow expectations of savers, risk metrics such as the mark to market value of an asset, its value at risk or its performance relative to an equity benchmark are very short term oriented and pro-cyclical indicators that provide the wrong incentives both for fund managers and investors.

We believe that there is a need not so much to develop new specific long-term benchmarks, as some already exist,<sup>32</sup> but rather to standardize them and encourage their use.

Long term benchmarks would facilitate a more appropriate risk assessment, reduce the short term pressure on fund managers and encourage less procyclical behaviour due to the qualitative elements that they often include.

The use of long term metrics derived from corporate finance may also promote a welcome shift in the concept of risk, reduce financial analysts' and CFOs' obsession with the volatility of asset prices and the smoothness of earnings, as well as investors' excessive focus on liquidity.

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<sup>32</sup> They include non-financial information like a periodic review of the validity of the underlying assumptions and fundamentals of the project measured against the economic cycle, a tracking of the interim changes in cash flow/income from the investment, appropriate internal rates of return, absolute return or liability driven benchmarks instead of market indices (see World Economic Forum: the future of long-term investing).

While the complementary use of short term benchmarks can be useful to provide short term accountability, in some cases its relevance needs to be questioned, for example in the case of illiquid long term assets where a low short term volatility of asset prices can come from out-of-date prices rather than low risk.

We also believe that it would be desirable to promote a different use of the existing short term metrics to monitor trends over longer horizons, such as the moving average of asset prices.

A critical approach to benchmarks and related communication to investors should be encouraged as well, given that all benchmarks have their limits and that absolute performance should be encouraged over relative performance, in order to reduce herding behaviour.

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

Before answering the question, we want to make a few remarks:

Firstly, while SME financing is clearly part of financing the real economy for productive use, it is a very different topic than infrastructure financing and does not obviously qualify as long term financing, given the average loan maturity. We are thus not convinced of the benefits of bundling together such different assets involving such different risks and maturities together.

Secondly, even though we fully recognize the benefits of alternative sources of finance, we want to reiterate our conviction that bank lending is and should remain the main source of funding for SMEs, among other reasons because banks will always be in a better position to assess risk due to their lasting personal and global relationships with borrowers, which enable them to incorporate essential qualitative elements in the risk assessment.

As a comparison, current risk assessment methodologies used in securitisation are focussed instead on concentration, diversification of the portfolio, solvency ratios and bank support.

Banks can also provide a greater variety of loan features suited to SMEs. We would thus welcome in parallel to this initiative a tighter deleveraging supervision with a view to ensure that bank lending to SMEs does not decline significantly.

We fully support the proposals to develop venture capital, an EU private placement market and standardized information more focussed on qualitative elements, but have reservations on some of the other proposed measures.

Developing specific accounting rules for listed SMEs in particular might be a debatable development as it may have an adverse impact on investors' confidence and create a two-tiered approach with a cliff effect once SMEs grow above the threshold.

Developing credit scoring standards for SMEs is also a debatable proposal, in a context where several banks are going through the opposite process, as their scoring models were based on flawed growth assumptions and failed to predict the crisis. While we support the standardisation of information disclosure, we believe that scoring would risk being focussed on quantitative elements when SME risk assessment requires precisely a focus on qualitative elements.