Finance Watch
Making finance serve society

Finance Watch response to the consultation Capital Markets Union mid-term review 2017

Brussels, 17 March 2017

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, 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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Only the questions that are relevant to Finance Watch are reproduced here.
We agree to the publication of this response.

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Finance Watch welcomes the Capital Markets Union mid-term Review and supports some of the key initiatives such as addressing the debt - equity tax bias and developing common definitions and standards on sustainable finance.
The review confirms however that some concerns we have raised in the past, together with other civil society organisations and academics, remain to be addressed.

1. CMU seeks to better connect savings to investment. We understand this to refer to the push to shift retail savings away from bank deposits and towards capital markets to provide rewarding investment opportunities for savers and retirement provision.
This raises many concerns: not only might this increase the risk of mis-selling but it might also give the erroneous perception that investing in capital markets will increase returns all other things equal. Yet there is no such thing as a "free lunch", or in other words investing in capital markets does not increase returns per se for the same amount of risk. This is particularly problematic if we understand this push to be linked to the forthcoming privatisation of pensions.

2. CMU seeks to enhance private risk-sharing. We understand this to refer to the promotion of public private partnerships, despite their mixed track record, generally higher cost for the taxpayer and their assessment as "budgetary time bombs".

3. CMU aims to provide alternative sources of financing and break the EU's reliance on bank lending. Phrased differently CMU is promoting non-bank lending (also called shadow banking) over traditional banking. This raises a number of concerns:
Firstly, while the European economy is indeed relying significantly on bank lending, this is not the same as being over-reliant.
Secondly, there is a wide academic consensus on the fact that whether an economy is financed by banks or capital markets has no meaningful impact on growth. It follows that there is no valid case for governments to promote one type of financing over the other.
In addition, while being reliant on bank lending exposes companies to banks reducing lending, being reliant on capital market financing might arguably be even more problematic, given the higher volatility of capital markets.

4. CMU aims to remove obstacles to the free flow of capital across borders to strengthen the Economic and Monetary Union.
While we support the integration of capital markets, pursuing European integration via capital markets will likely never be a stable alternative to fiscal union.
The recent crisis has shown indeed that the temporary convergence of borrowing rates for different Members States led to a brutal divergence when confidence disappeared.

5. CMU claims to support the strengthening of banks. Yet it rather supports a very specific banking model: the universal and investment banking model that had to be bailed out during the crisis. Promoting STS securitisation will mostly benefit TBTF universal and investment banks, as these are the ones that will manufacture and use securitisation.

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Securitisation is not the appropriate instrument to support SME funding. The pooling of several SME loans for securitisation purposes makes it difficult for investors to assess the "real" underlying credit risks of the securitised bond. Finance Watch advocates simple and easy understandable financial products with transparent risk and return relations. This is not the case for Asset Backed Securities that securitise a portfolio of heterogeneous SME risks and use the water-fall strategy of tranching. These products are neither simple nor easy to understand nor transparent in regard to the underlying risk.
Furthermore, due to a lack of trust investors are currently buying only senior tranches of securitisations, while the junior tranches remain with banks and still burden their balance sheets. The result is a kind of adverse selection: bad risks for the banks and good risks for the market. This is not a wise solution and contradicts the original idea of the CMU initiative.
The reality is that investors will only be willing to buy all tranches of SME bonds if they come with a public guarantee. In this case, freeing up bank balance sheets from bad risks by establishing a state owned bad bank would be a cleaner and more efficient solution.

Question 1: Are there additional actions that can contribute to ***fostering the financing for innovation, start-ups and non-listed companies****? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.*

We support increasing the availability of seed or venture capital in Member States where a shortage of offer for start-ups has been identified. It is however important to bear in mind that high growth potential companies or start-ups represent less than 10% of European SMEs.
According to the ECB SAFE surveys, there is no overall shortage of funding for European SMEs – it's much more on the demand side (filling the order book) that SMEs would need support.

To foster access to financing for start-ups where needed, crowdfunding might be a complement to bank lending. But in this field the EU's initiatives so far are limited to the collection of data and information via workshops, setting-up a stakeholder group, and providing financing for studies and surveys. Despite the European Commission's current Action Plan on reaching a unified European Capital Markets Union (CMU) there is no bespoke, single European regulatory framework for crowdfunding, crowdinvesting or for peer-to-peer lending. The crowdfunding market in the EU is highly fragmented as the regulation of crowdfunding in Europe remains the task of national legislators and national financial authorities. A uniform European regulation would give financial service platforms and their users the necessary legal confidence and certainty to expand their activities freely within EU borders without national legal barriers. However, the EU regulation for crowdfunding must ensure a fair treatment of platform users, both SMEs and retail investors.

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*Question 3: Are there additional actions that can contribute to **fostering long-term, infrastructure and sustainable investment**? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.*

For more detailed recommendations related to making the financial system contribute to sustainability goals in the framework of this CMU mid-term review, see this joint civil society report.

We welcome and support the objective of fostering common definitions and standards in sustainable finance at a time where green finance and instruments such as green bonds are growing quickly.

Investor trust is fragile, hard to build and easy to destroy. To foster this trust, a common framework with robust and binding criteria must replace loosely defined quality labels defined by the industry.

Amongst other elements, well-known issues such as the lack of additionality in several carbon offset projects financed by green bonds should be specifically addressed as soon as possible to ensure the credibility of these instruments.

We welcome the creation of a High Level Expert Group on sustainable finance. Any consultations on its recommendations should be designed to make it as easy as possible for citizens and civil society representatives to participate.

The HLEG is a temporary body however and the inclusion of sustainability criteria in financial policymaking needs to be permanent. As a start, we would like to see the Sustainable Development Goals given a central role in the EU's policy processes, especially consultations, impact assessments and legislative reviews, and the objectives of financial policymaking, for example as expressed in the mission statement of DG FISMA, amended to include sustainable finance objectives.

*Question 4: Are there additional actions that can contribute to **fostering retail investment**? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.*

In our view, complementary policy measures are necessary to ensure that fostering retail investment does not lead to additional mis-selling:

It is well known that the concept of risk and reward is poorly understood, leading in many cases to retail investors believing in misleading and unrealistic return promises combined with allegedly little risk.

We also know that financial education has an extremely limited impact.

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Excellent initiatives such as key information documents, designed using behavioural economics or to ensure the most appropriate default options, do contribute but are also not sufficient to offer an adequate level of protection.

In addition, relying on the growth of cross border digital providers of financial services to increase competition, lower fees, provide better products and curb mis-selling would also be very optimistic in our view: experience shows that after an initial phase of competition the model of online players tends to be winner takes all, leading to reduced competition and more too-big-to-fail.

Current regulation focuses on point of sale advice and disclosure. Yet there is compelling evidence that mis-selling can stem from flawed product design: when a product includes features that systematically lead to mis-selling, whether because it is excessively complex, references unusual and exotic asset classes or plays on behavioural biases. This is currently softly addressed through the warning label in PRIIPs.

Should we promote retail investors' direct involvement in capital markets, it would be necessary in our view to strengthen how we address the issue of flawed product design through product rules or mandatory enhanced disclosure.

When it comes to P2P lending – to foster retail investor trust in this area – there is a need to define harmonised disclosure standards. Lenders are currently warned that P2P-investments could lead to a total loss of the invested amount, in accordance with EU consumer protection law. However, this information does not empower lenders to conduct a risk-return analysis by comparing the performance statistics of competing P2P lending platforms and so make a rational investment decision. Clearly, every platform publishes investment statistics including gross interest rates, bad debt rates, default rates etc. on its web page and clients normally receive monthly performance statistics for their individual portfolio. But the methods used for calculating the risk-adjusted net returns differ considerably from platform to platform because national laws and regulators have yet to define a common standard for measuring the performance of P2P-loan investments. Furthermore, there are no disclosure standards for information about borrowers or about platforms' credit assessment methods. This makes it impossible for investors to assess and compare the quality of platforms and so make a careful selection of the "right" platform.
Some of the most relevant consumer protection standards are, nevertheless, protected in EU directives and implemented in national law, such as the right to withdraw from a contract within 14 days, and the right to receive minimum pre-contractual information in order to conduct a creditworthiness assessment and to determine the cost of credit. Furthermore, the EU Directive on Unfair Commercial Practices protects consumers against activities such as providing untruthful information to consumers or using aggressive marketing techniques to influence their choices. Nevertheless, there is a substantial difference between defining legal disclosure standards for P2P platforms and the existing legal requirement that any promotion of P2P investments be carried out in a manner that is fair, clear and not misleading. Regulators still have to define the disclosure of standard information for retail investors in P2P, which should integrate as well the findings of behavioural economics. Inspiration can be taken from the legislative work carried out on Key Information Documents for UCITS and PRIIPs.
Given the fact that platform users receive limited information about the borrower as well as about the platforms' credit assessment methods, they ultimately need a good deal of trust when investing their money in P2P loans. However, this trust is not justified, as a natural conflict of interest exists between the

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platform's business model and investor protection. Both the platforms and the borrowers have some incentive not to be too critical concerning the disclosure of risks. The platforms generate their income through a fee that usually corresponds to a certain percentage of the transaction volume. This payment model provides a steady incentive to stimulate the platform's transaction volume by exaggerating investment opportunities and profit chances, while the risks of investment projects are rather played down or concealed. Additionally there is some risk that platforms seeking to increase their turnover quickly could grant more favourable treatment to institutional investors that have a higher transaction volume than retail investors. This could lead to institutional investors being allowed to cherry-pick loan offers or buy up an entire issue before retail investors have an opportunity to invest.

Question 5: Are there additional actions that can contribute to strengthening banking capacity to support the wider economy? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

Ten years after the financial crisis the EU banking sector continues to suffer, in many places, from overcapacity, poor capitalisation and asset quality, and a structural lack of profitability. Measures needed to restore the banking sector to health have been postponed or diluted to the point of ineffectiveness. In order for the banks to fulfil once again their role in financing the real economy the underlying problems must finally be tackled.

- The problem of "too big to fail" banks and the vicious circle of bank/sovereign contagion still has not been broken. The EU is home to thirteen global systemically important banks and nearly a hundred domestic ones. They have barely changed in size or number over recent years and efforts to impose structural reforms, as proposed by the Liikanen Report, have failed. International institutions, such has the IMF, continue, at regular intervals, to single out EU banks as a major risk factor for global financial stability. As long as banks are able to cross-subsidise certain activities with inexpensive funding that would otherwise support their conventional businesses capital allocation is likely to remain distorted, to the detriment of real businesses that depend on bank funding.

- The removal of large volumes of NPLs should, in the first instance, be achieved by way of resolving the banks that have been responsible for poor-quality lending. In order to restore a competitive level playing field, and the effectiveness of the banking sector as a channel for financing the real economy, weak banks must be allowed to leave the market in an orderly way. The resolution regime offers a number of ways of achieving this objective without burdening the taxpayer. Member States must be obliged to apply the Bank Recovery and Resolution Directive and allow for the orderly winding-down (i.e. liquidation or resolution) of banks which are no longer viable. The use of so-called "precautionary recapitalisations" as a way of rubber-stamping State-sponsored bail-outs must be reined in. Art. 32/4 BRRD needs to be reviewed as a matter of urgency and the conditions for so-called "precautionary recapitalisations" tightened so that they become the exception rather than the "new normal".

- As set out before, we are very sceptical about the concept of securitising large volumes of NPLs. Firstly, the expected impact is likely to be significantly smaller than suggested because banks would have to recognise the write-down ("haircut") immediately upon sale. In addition, only the senior tranches are

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likely to be saleable in the market, still leaving the bank exposed to the riskiest tranches of the structure. Secondly, the concept of selling complex, structured products based on poor-quality credits through captive distribution channels with significant information asymmetries is ominously reminiscent of the practices that led to the last financial crisis.

- Leverage in the banking system continues to be excessive. Whereas we welcome the introduction of the Leverage Ratio as an additional measure of capital adequacy we agree with the assessment, put forward by the OECD and BIS, among others, that its calibration is unsatisfactory, lacks regulatory impact and thus severely limits is usefulness. “Risk-sensitive” capital adequacy rules, often based on banks’ internal risk models, continue to prevail, despite their by now widely recognised shortcomings. Finance Watch supports the Basel Committee’s recent proposals to restrict the use of internal models (F-/A-IRB approaches) and introduce “output floors” to limit the divergences between different risk modelling approaches.

- Many proposals have been formulated to address the excessive procyclicality of lending such as curbing the re-use of collateral and introducing minimum haircuts in securities financing transactions and we strongly hope to see them implemented in level 1 legislative proposals in the near future.

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