Finance for Europe

Accelerating Capital Markets Union

AFME's response to the CMU Mid-Term Review consultation

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Association for Financial Markets in Europe
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Introduction

With capital market financing still underdeveloped in the EU compared to traditional bank finance, the case for CMU remains valid and compelling. AFME believes that the CMU project is more important than ever to create jobs and increase growth and investment, as well as to improve the functioning of the European financial sector. The development of well-functioning cross border capital markets remains crucial to support start-ups and high growth potential companies as well as to provide investors with reasonable returns in times of low interest rates.

The CMU project is well underway and significant efforts have been undertaken so far to establish the right conditions for developing Europe's capital markets. Important steps taken include the agreement reached on the review of the Prospectus Directive, the Call for Evidence on the regulatory framework for financial services as well as the progress made with regard to the STS securitisation proposal. It is important to keep up the pace in the second half of the Commission's term to ensure the momentum is maintained.

With several actions from the CMU Action Plan either having been launched or in the pipeline, this is a good time to reflect on additional actions and priorities set for the coming period. For the second half of the CMU project, the following three overarching objectives should be pursued:

- **address Europe's shortage of risk capital:** particular focus should be given to the promotion of risk capital for Europe's high growth businesses. Europe's shortage of risk capital for high-growth sectors, such as technology, is a pressing issue. The Commission and co-legislators should prioritise actions that would make risk capital more widely available to those who need it;
- **maintain and promote well-functioning secondary markets**: well-functioning secondary markets are key to the success of capital markets providing financing opportunities for companies who need it and creating suitable investment opportunities for savers. Policymakers should continue to focus on preserving and enhancing market liquidity, particularly by considering the impact of market conduct regulations and CRR II rules on the functioning of wholesale markets. These include calibration of the Fundamental Review of the Trading Book, application of the Leverage Ratio and the NSFR rules related to repos and derivatives;
- **deliver on the actions already in train**: following thorough analysis and consultation, the Commission published its CMU Action Plan in 2015 which already contains many important initiatives that should help to develop Europe's capital markets. It is important that all actions are delivered on and Member States need to act swiftly to address the barriers identified. Where introducing reforms is difficult, assistance should be provided by the Commission who should focus on making sure that the CMU initiative delivers results for all Member States.

A number of crucial legislative proposals have already been published or are under consideration by the Commission and these will be instrumental to the success of CMU (e.g. securitisation, insolvency reform and securities law reform) and it is important that the co-legislators prioritise delivering on these files in the second half of the Commission's mandate. We agree with the Commission that CMU also requires commitments by Member States to tackle national barriers as recently identified by the expert group of national experts[1].

We believe that in order to deliver on the above key objectives, the focus in the second half of the Commission's term should be – in addition to the actions which are already underway – on the following ten policy priorities:

1. the importance of supporting **alternative forms of financing** in the pre-IPO phase;
2. support **SME growth markets** further to provide a source of finance for growth companies;

[1] European Commission report on 'Accelerating the capital markets union: addressing national barriers to capital flows'

3. the need to focus on **less developed capital markets** and how CMU can help to develop them, recognising the role that regional markets can play in this context;
4. **the need to focus on sustainable finance and infrastructure as key asset classes** to support long-term economic growth;
5. the importance of progressing the **regulatory review** agenda to make sure that the regulatory framework supports capital markets, both those which are established and others which are less developed. Regulatory consistency and coherent calibration is fundamentally important in ensuring that wholesale markets fulfil their role in matching investors and investment opportunities globally;
6. the need for further national **pension reforms**;
7. well-functioning **secondary debt markets** for existing markets such as investment grade corporate bonds, and enhancements for less liquid or illiquid markets**,** for example ABS and NPLs;
8. the importance of maintaining a **robust secondary market infrastructure** to facilitate capital raising and trading, including having appropriate best execution and reporting requirements;
9. addressing the **withholding tax** barriers currently in place and consider the options for going beyond the recommendations that have already been made to Member States;
10. the **global context** of CMU by arguing in favour of open capital markets which operate with a sensible equivalence framework, all supported by **well-functioning ESAs**.

As the Commission continues to make progress in delivering the priority actions of the CMU Action Plan, we welcome the intention to report regularly to the European Parliament and Member States on progress and the continued work in identifying main inefficiencies and barriers to deeper capital markets.

Measuring the success of CMU is important and should not only be done by considering to what extent the actions from the CMU Action Plan have been accomplished but also what effect they have had. We therefore argue that the Commission should develop **Key Performance Indicators (KPIs) for CMU** to be able to track progress made in developing Europe's capital markets. The KPIs seek to measure the evolution of key statistics relating to market depth, size and integration of European capital markets covering each of the six main actions of the Commission's CMU action plan. KPIs could be a useful tool to monitor actions and regimes at national level that encourage the development of capital markets financing, thus also providing an incentive for Member States to undertake actions that facilitate the objectives of CMU.

We suggest the Commission compile and monitor proposed key indicators and prepare diagnostic publications seeking to identify the positive impact that the CMU has on the European economy as Member States implement the policy actions of the CMU agenda. The reports would also help identify any shortfalls or areas that additional amendments or reforms are necessary.

The Commission has shown strong leadership in the CMU project and we hope it will continue to do so in the coming period. AFME remains strongly committed to CMU and looks forward to working together with legislators to make sure that the building blocks of a successful CMU are being put in place by 2019.

Content

Overview of recommendations

1. Financing for innovation, start-ups and non-listed companies

Lead	Recommendation
Commission	• Establish an EU expert group focusing on improving the start-up market • Publish Recommendations on the appropriate regulatory framework for crowdfunding • Create a passport for business angel investors • Study exit opportunities for angel investors • Consider ways to promote the development of market research on companies raising money through crowdfunding platforms • Consider ways to promote the development of market research into business angel investments • Consider need for introducing standardised documentation for (quasi-)equity financing • Amend MiFID II and AIFMD to ensure that “sophisticated” or “semi-professional” investors are recognised as a specific investor category • Conduct a study into the existing tax incentives available for business angel investments and publish Recommendations on best practices • Conduct a study into the different legal frameworks for venture debt and consider need for EU level action • Study the feasibility of a financial instrument issued to a group of companies involved in a business value chain rather than to a single company • Leverage the ESIL pilot project • Broaden the mandate of the EIAH by also tasking them with assessing investments and potential exit strategies for business angels • Consider options for developing SME advisory ecosystems
EIF	• Expand European Angels Fund to more Member States • Expand its mezzanine fund of fund making it available to more Member States

2. Making it easier for corporates to raise finance on public markets

Lead	Recommendation
Commission	• Consider which changes could be made to the MiFID II SME Growth Market regime to encourage its use • Take the Call for Evidence follow ups forward swiftly • Repeat the Call for Evidence in a couple of years’ time • Consider industry input on CRD V/CRR II proposals • Focus on best to tailor the CMU programme to benefit countries with less developed capital markets • With Member States continue the efforts towards developing the financial market infrastructure, simplifying trading and guaranteeing appropriate levels of market liquidity • Study capital gains tax regimes setting out best practices and country specific recommendations • Study and make recommendations for how countries could encourage entrepreneurships
Member States	• Allocate sufficient staff resources to develop capital markets. Commission to assist where necessary through the SRSS • Ease investment regimes to allow investment in wider variety of assets • With industry help educate retail investors about personal finance and the benefits of diversifying away from bank deposits

	• With exchanges support local issuers seeking to access capital markets • Consider their role in encouraging state-owned enterprises (SOEs) to lead the way in capital markets via bond issues or IPOs
EBRD, ECB, Commission	• Provide support to develop necessary capital market reforms

3. Investing for long term, infrastructure and sustainable investment

Lead	Recommendation
Commission	• Review national procurement legislation • High Level Expert Group on Sustainable Finance to consider how best to interact with the banking sector to ensure that the banking sector voice is heard • Consider how best to work with the FSB Task Force on Climate-related Financial Disclosures
EU and national institutions	• Leverage European Investment Advisory Hub's work, make it more visible and reach more public authorities

4. Fostering retail investment and innovation

Lead	Recommendation
Commission	• Consider how to provide support in building up legal framework to develop national pension systems
Commission and Member States	• Take forward the work on the creation of a single market for personal pensions in close consultation with industry • Look into promoting the use of automatic enrolment

5. Strengthening banking capacity to support the wider economy

Lead	Recommendation
Commission	• Launch a public consultation seeking to identify best ways to develop a secondary market for NPLs
Co-legislators	• Address key elements of the STS framework

6. Facilitating cross-border investment

Lead	Recommendation
Commission	• Introduce a conflict of laws rule for all securities held through securities accounts • Consider conducting the ESA review in two stages • Consider the global context of CMU
Commission and Member States	• Take forward the actions identified by the European Post Trade Forum • Consider ways for harmonising fiscal processes for market claims
Member States	• Implement a standardised and harmonised system for tax relief at source and introduce simplified tax refund procedures
ESMA	• Focus on supervisory convergence

1. FINANCING FOR INNOVATION, START-UPS AND NON-LISTED COMPANIES

Question: *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.*

Among the 23 million SMEs in Europe, only a fraction are high-growth businesses, which expand and invest rapidly and in the process create new jobs. For example, in Belgium early stage small firms represent 17% of total employment but 41% of job creation, according to the Belgium's Federal Planning Bureau[2].

In the AFME Boston Consultancy Group (BCG) *Bridging the growth gap* report in 2015, BCG compared small business finance in Europe and the US. The report found that European SMEs have more financing available than their US counterparts. For example, there is€2tn of funding in Europe available for SMEs compared to €1.2tn in the US. But of that €2tn in Europe, 77% was in the form of loans or debt compared to only 40% in the US[3]. So while, European SMEs have more overall funding than US SMEs they do not have the same availability of risk capital, whether in the form of equity or venture debt (quasi-equity).

There is a clear need for a regulatory framework that encourages institutional investors, such as insurance companies, fund managers and pension funds, to invest in both equity and debt of unlisted SMEs.

In the area of equity, the share of equity investments in total investments of insurance companies and pension funds has declined over the last decade and one of the key underlying factors of this significant shrinking in equity holdings was the expectation of Solvency II implementation and its conservative capital requirements. For debt issued by qualified SMEs, we recommend that the current capital charges for insurers be reviewed to see whether there is scope to reduce capital charges for SME loan or bond funding, in a similar way at the SME Scaling Factor exists in the banking system.

Small businesses with stable cash-flows and a historical track record are able to rely on bank finance and debt. However, young and innovative companies which lack these characteristics are often not profitable therefore require alternative forms of financing in the form of equity or quasi equity in order to grow.

Young and innovative companies are a core engine of Europe's economic growth. Making sure that these companies are able to finance themselves should be a core objective of policymakers and industry. The Commission has taken important steps during the first half of the CMU project for example by putting forward a proposal to revise the EuVECA legislation as well as launching the initiative of a pan-European venture capital fund-of-funds and multi-country funds as part of the Commission's Start-up and Scale-up Initiative[4]. The Commission has also taken an important step to address the debt/equity bias in the tax system by proposing the introduction of an allowance for growth and investment in the CCTB proposal. This would incentivise the use of equity finance and it could be decided to only make the allowance for growth and investment available for SMEs, either as part of CCTB or separately, if it otherwise would lead to significant tax revenue losses.

We believe it is important to promote a capital market culture within the entrepreneurial and investor community in Europe. This can be done by improving the knowledge about access to financial instruments, create networks of entrepreneurs and investors and develop entrepreneurial programmes at universities.

But more needs to be done to develop the pre-IPO stage of financing for companies. AFME recently published a report "*The Shortage of Risk Capital for Europe's High Growth Businesses*" (link) which contains suggestions on how the access of high growth companies to risk capital could be improved. The report outlines the various

[2] In the UK, 60% of start-ups that survive their first three years in business create 42% of all new jobs, according to Nesta. . In the OECD, young companies are net job creators and have remained so in the 2007 – 2009 financial crisis
[3] AFME-BCG Bridging the growth gap, 2015
[4] Commission gives boost to start-ups in Europe, 22 November 2016

and inter-dependent sources of financing available in the EU to high-growth businesses (including family and friends, accelerators, equity crowdfunding, business angels, venture capital, venture debt, public markets and public funding) and highlights that many of these are underused. The report identifies the key barriers to accessing risk capital and makes recommendations to policymakers and the industry for how these barriers could be addressed.

Different solutions will be needed for different forms of finance from family and friends financing at the smaller end of the spectrum until the IPO stage or a trade sale. The below sets out our key recommendations for initiatives the Commission and others could undertake in the coming period to support the financing of non-listed companies:

1.1 A fragmented start-up market

- Establishing a single EU framework for start-ups with standard rules across the 28 EU Member States would enable young businesses to scale-up across borders and facilitate access to 510 million customers. This could be done through the **establishment of an EU expert group** to focus on the revision of the various EU legal frameworks, insolvency laws and tax incentives for investors in start-ups. There is already momentum for such a transformation with the recent report from the Commission on addressing national barriers to capital flows and the recent Commission Start-up and Scale-up Initiative, including the proposal for an Insolvency Directive.

1.2 Family and friends

- Family and friends often play an important role in the start-up phase of a company. They provide the company with the necessary risk capital at the early stages of growth. It is important to make sure that the finance provided is appropriately organised and documented as not doing this could have a negative impact on the chance of additional rounds of professional finance. Having access to standardised documentation for equity and quasi-equity financing for this type of finance is important for companies. **The Commission should assess the availability of such documentation at a national level and consider introducing standardised documentation that can be used across the EU.**

1.3 Equity crowdfunding

- A number of Member States have introduced legal frameworks for equity crowdfunding. These have led to inconsistencies and uncertainties and are in some cases restrictive. This makes it difficult for crowdfunding platforms to scale-up and unlock cross border investments. We would therefore argue that it is important to develop a common EU framework for crowdfunding and exchange best practices. This could be achieved by the **Commission publishing Recommendations on the appropriate regulatory framework for crowdfunding** based on best practices and building on the Commission report on the EU crowdfunding sector from 2016;
- Crowdfunding investors require sufficient information about the company that is looking for finance in order to be able to invest. Such transparency is necessary so that all the risks are fully disclosed and understood in order to prevent possible mis-selling to unsophisticated retail investors. Market research could help in this area. The definition of eligible investor as used in Member States should be reviewed and possibly harmonised if they are found to be diverging too much. We would recommend the **Commission to work together with the crowdfunding and business angel community on solutions that could promote the development of market research** on companies raising money through crowdfunding platforms;
- The European Crowdfunding Network, together with Business Angels Europe, and others are working with smaller EU Member States and the Commission in a pilot project call the Early Stage Investing Launchpad Pilot (ESIL) which is aimed at developing crowdfunding and business angels in three

Member States. **We would recommend that the Commission leverages this pilot project across all EU Member States to promote crowdfunding**;

- A missing link in the funding escalator is represented by the poor exploitation of synergies and co-financing opportunities between companies that have successfully raised (or that are about to) a first round of funding through crowdfunding and the banking sector. In order to enhance a mutually beneficial interaction between start-up and the banking world it would useful to develop bankability indicators to be disclosed (on a voluntary base) by companies active on crowdfunding platforms in order to help banks in the identification of projects which are mature for bank financing. Once the indicators are developed, ad-hoc European platforms could be created in order to make projects and the relevant information available to the investor community. The development of such platforms would avoid viable companies, which have already been successfully screened by crowdfunding investors and are ready for scaling-up their business, to be underfinanced or limited in their growth potential.

1.4 Business angels

- Business angels are very important for start-up companies that are looking to grow. They can provide an amount of finance that can elevate companies from an initial, start-up phase to the next level and allow business to expand. To make cross border investments by business angels easier, we believe it is important to create a single market for business angel investors, as well as their syndicates and networks. To this end, we would recommend the **Commission, working together with business angels, to create a passport for business angel investors**. This would make it easier for business angels to both invest cross border but also continue to invest in companies that are looking to expand cross border, possibly together with a syndicate of angels in other countries. The introduction of a passport requires the development of a common accreditation or qualification system for business angels, which is already required in some EU countries;
- At the moment, the European Investment Fund also co-invests with business angels at various stages of development through the European Angels Fund (EAF). The EAF is limited to certain Member States but has the potential of increasing the size of first time and follow-on business angel investments considerably. We would recommend that the **EAF is expanded to also cover other Member States than those currently involved** in the project;
- The European Investment Advisory Hub (EIAH) has been very important in promoting the investments in infrastructure projects in the EU. We believe that the EIAH could also develop its expertise and play an important role in helping business angels. We would therefore recommend to the **Commission to broaden the mandate of the EIAH by also tasking them with assessing investments and potential exit strategies for business angels**. This could for example be achieved by arranging workshops and seminars;
- The lack of exit opportunities sometimes prevents business angels from investing in companies in the first place. To tackle this problem, a privately or publicly funded platform for secondary transactions in business angel investments could be established. We would recommend the **Commission to study the possibilities for this and consult market players on this**;
- The exit opportunities for business angels are also limited now because of a lack of business information as well as inconsistencies in data that is available. It would be worth for the **Commission to build on its current data gathering initiative and work with European Business Angels Network and Business Angels Europe to support market research into business angel investments**;
- Member States currently have different tax incentives to promote business angel investments. These inconsistencies can make it more difficult for business angels to invest cross border limiting investment opportunities. Aligning the tax frameworks which are aimed at incentivising angel investments would be desirable. To this end, we would recommend the **Commission to conduct a**

study into the existing tax incentives available and publish Recommendations on best practices.

1.5 Venture capital (equity)

- We are supportive of allowing a broader range of fund managers to invest in start-ups and scale-ups to benefit from the voluntary EuVECA passport and have expressed this in our response to the EuVECA consultation[5]. We would encourage the Commission to make sure that, as the negotiations on the EuVECA Directive continue with co-legislators, the **broadening of which fund managers** can use the EuVECA label is preserved;
- At the moment, high net worth individuals cannot always invest in VC funds because of marketing restrictions. We would therefore be **supportive of amending MiFID II and AIFMD to ensure that "sophisticated" or "semi-professional" investors are recognised as a specific investor category**;
- Institutional investors have the potential of being important providers of venture capital financing to companies. Solvency II however has made insurers cut their commitments to private equity and VC funds substantially. We therefore welcome the calibration made to Solvency II to reduce the capital charges for investments in both VC and PE.

1.6 Venture debt

- The use of venture debt in Europe is underdeveloped and is small compared to the US. While it is difficult to get an overview, estimates suggest that 15-20% of all US VC is in the form of venture debt. This compares with 8-10% in the UK and 5% in Europe[6]. Improving the visibility and access of venture debt instruments and providers could provide extra finance for businesses to reach their next milestone without getting diluted. An important step could be reached for some businesses, allowing future potential fundraising with VC funds allowing businesses to scale-up and grow.
- Venture debt is a complement to equity financing in a form of debt financing provided to venture equity-backed companies that lack the assets or cash flow for traditional debt financing, or that want greater flexibility. We believe that it is important to promote the venture debt financing route to fill the gap that can exist between two VC equity rounds. To this end, we would recommend the **Commission conduct a study into the different legal frameworks for venture debt that exist in different Member States and consider whether any action at the EU level is needed**;
- The EIF has developed the Mezzannine Fund of Fund in Germany. This fund of fund has the ability to provide additional certainty and financing in when providing venture debt to companies. We would recommend that the **EIF expands this fund and makes it available to other Member States as well**.

1.7 Public markets (see also our response to question 2 on SME growth markets)

- When companies decide to move from the pre-IPO phase to access public markets, it is important that a sufficient number of investors is available. For this, action should be considered to enlarge the current spectrum of professional investors. MiFID II could help in this respect by adjusting the mechanism whereby investors which are currently considered to be "retail investors" can be treated as "professional investors". This could expand the pool of potential professional investors in companies looking to raise finance on public markets. We recommend the **Commission consider the options for achieving any changes this respect during the next review of MiFID II**;
- The Commission should **consider options for how it can support the development of SME advisory ecosystems** of issuers, investors, advisors, entrepreneurs, academics and European centres of innovation such as science parks.

[5] AFME response to Commission's EuVECA consultation, here
[6] E&Y and "Scale-up UK" report.

Finally, in order to foster the creation of new "circular" business models and the cooperation among enterprises operating in the same value chain, we suggest the **launch of a feasibility study on a financial instrument issued to a group of companies involved in a business value chain rather than to a single company**. The underlying argument being that the merit of each enterprise is enhanced by the cooperation generated in the value chain justifying overall better financing condition (the instrument could receive favorable prudential treatment). The funding could be supplied to some kind of "special purpose vehicle" or could be shared between the enterprises of the value chain according to their necessities, with a common pricing which should consider the value added of the whole project.

2. MAKING IT EASIER FOR COMPANIES TO ENTER AND RAISE CAPITAL ON PUBLIC MARKETS

Question: *Are there additional actions that can contribute to making it easier for companies to enter and raise capital on public markets? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.*

2.1 SME growth markets

MiFID II, when it enters into force on 3 January 2018, introduces a new category of MTFs; the SME Growth Markets. These growth markets have the potential for providing a useful platform for small and mid-size businesses looking to raise capital on public markets.

For SME growth markets to be successful, liquidity in SME shares needs to be substantial enough to attract investors to invest in shares in the primary market. Without sufficient liquidity in secondary markets, investors will be reluctant to invest as there might not be an exit opportunity at the time when needed, or the price of exit might have to be at a substantial discount to the share of the value of the underlying assets of the business.

MiFID II contains provisions which are aimed at encouraging the development of SME growth markets, but these provisions contain no added benefit or incentivisation to set up these markets, such that, as currently proposed, SME MTFs enjoy no secondary trading benefits over and above ordinary MTFs.

This leads to the situation where, at the moment, despite all the best intensions, there is no regulatory, nor commercial, incentive to set up SME MTFs. We would therefore **recommend the Commission to consider which changes could be made to the MiFID II SME Growth Market regime to encourage its use.**

In addition, the new MiFID requirements for research are expected to have a negative impact on the development of research which could stimulate investments in SME growth markets.

2.2 Focus on less developed capital markets

The size and depth of capital markets is not equally distributed across Europe. Some countries have significantly deeper capital markets than others which rely more heavily on traditional bank lending. The high potential economies in Central and Eastern Europe (CEE) in particular have been identified as being able to benefit significantly from more developed capital markets[7].

The experience of the CEE region since the crisis suggests that a reliance on bank financing has held back growth. Bank lending represents 85% of corporate debt in CEE countries compared with 75% in the EU. Economic growth in these economies has virtually halved since the financial crisis, productivity growth has slowed and the rate of convergence with the rest of the EU has stalled. The impact of the crisis was more severe for countries that entered the crisis without developed alternative forms of financing outside bank lending to supplement the rapid shortfall of bank loans. Countries with deeper capital markets and larger pools of long-term capital, like pensions or insurance assets, have seen less shrinkage in GDP growth rates in the period since the crisis.

While there is not a simple, single solution to accelerate the development of capital markets in these countries, it is positive that local governments and organisations such as the EBRD recognise the need for capital markets and are already doing much to encourage their development. **We believe it is important that the Commission, for the second half of the CMU project in this term, focuses on how best to tailor the CMU programme to benefit countries with less developed capital markets.** The CMU project needs to go

[7] AFME-New Financial report "The benefits of capital markets to high potential EU economies"

beyond the existing agenda to deliver the most meaningful benefits for countries with less developed capital markets.

In order to achieve this, CEE Member States, the Commission and industry need to work together to develop the full potential that capital markets can provide to this region. We very much **support the Commission's approach of providing assistance through the Structural Reform Support Service (SRSS)** to Member States who request it. In a recent publication with New Financial, we identified ten actions that could be taken that would promote the development of deeper capital markets in these CEE Member States[8]. The overview of recommendations below includes actions to be taken by Member States, industry and the Commission and we have highlighted areas where the Commission could play a further role of assistance:

- ease the investment regimes of local institutional investors to allow investment in a wider variety of assets;
- encourage the diversification of the sources of financing for growth companies at pre-IPO stage (please see our response to question 1 for more details on how the Commission could assist with this);
- continue the efforts towards developing the financial market infrastructure (trading platforms, CCPs and CSDs) simplifying trading and guaranteeing appropriate levels of market liquidity;
- strengthen the business environment to encourage entrepreneurship, ease the regulatory burden on businesses, and help boost the functioning of capital markets and the wider economy. We would **recommend the Commission to conduct a study leading to recommendations for how countries could encourage entrepreneurships**;
- simplify the tax systems, including simplification of capital gains tax and withholding tax. We encourage the Commission to continue the work they have started with regard to simplifying withholding tax regimes and would also **welcome a report by the Commission on capital gains tax regimes setting out best practices and country specific recommendations**;
- governments and institutions can help educate retail investors about personal finance and the benefits of diversifying away from bank deposits;
- as part of financial literacy programmes, governments and exchanges can support and accompany local issuers along the path towards accessing capital markets;
- national governments should guarantee the availability of sufficient staff resources at Ministries of Finance, Supervisors and Central banks to develop and implement financial regulation and supervision. Where necessary, the **Commission could be asked to assist through the SRSS**;
- national governments could consider their role in encouraging state-owned enterprises (SOEs) to lead the way in capital markets via bond issues or IPOs;
- European institutions like the EBRD, the ECB and the **Commission can provide valuable institutional support to develop the necessary capital markets reforms** tailored to the local business environment, and provide technical assistance for the implementation of local reforms and EU legislation.

In addition to the above recommendations, we are **very supportive of the proposal from the European Investment Bank to set up a Commission-led expert group on CMU** which would focus on issues faced by CEE countries.

[8] AFME-New Financial report "The benefits of capital markets to high potential EU economies"

2.3 Regulation review agenda

Having the appropriate regulatory framework is crucial for making sure that the financial services industry is able to contribute to stimulating economic growth. The regulatory framework which has been introduced in recent years has made the banking sector significantly more resilient and has reshaped how financial markets operate. With the vast majority of the regulatory reform package being put in place, the Commission was right to start examining the cumulative impact of the regulations on the ability of financial services to support economic growth. Given the number of different regulatory reforms introduced in recent years, it is prudent to undertake an assessment of potential inconsistencies, overlaps and unintended interactions between different regulations. Addressing these issues would be important to make sure that the regulatory framework operates as anticipated and without any unintended effects.

In October 2015 the Commission launched a Call for Evidence on the EU regulatory framework for financial services and AFME submitted a comprehensive response[9]. A year later the Commission announced which follow-up actions it would take in response to the feedback received[10]. In there the focus was put on i) reducing unnecessary regulatory constraints on financing the economy; ii) enhancing the proportionality of rules without compromising prudential objectives; iii) reducing undue regulatory burdens, and; iv) making rules more consistent and forward-looking.

AFME welcomes that the Commission took into account the Call for Evidence feedback in designing the CRR II and CRD V proposals launched last November. In a significant number of areas, the Commission has also announced more analysis as part of forthcoming reviews of individual pieces of legislation (e.g. EMIR) or by consulting further to develop a deeper analysis of the issues (e.g. liquidity in the repo market). We would **encourage the Commission to take these announced actions forward swiftly**.

We welcome that the Commission intends to continue to monitor and analyse the impact of the regulatory reform agenda considering whether measures should be recalibrated in certain areas. In particular given that the Call for Evidence, as launched in 2015, was held at a time when not all agreed measures were yet introduced, it will be **important to repeat this exercise again in a couple of years' time**. This could then benefit from any analysis that is currently being conducted at a global level where the theme of regulatory review has been picked up as well. This would also enable policymakers and industry to reflect on measures which are about to be introduced, such as MiFID II and, in due course CRDV and CRRII.

In the context of MiFID II, ESMA and the Commission will issue interpretative guidance up until and indeed beyond the go live date. Having the opportunity to reflect on these again following the 'go-live' date is important. It would also enable policymakers and industry to reflect on the methodologies used in the MIFID/R annual assessments of liquidity. This is particularly relevant given the expected departure of the UK from the EU around the time the annual assessments of liquidity are being introduced. Having an opportunity at that time to rethink how and when that liquidity assessment should take place would be welcomed.

In the meantime, we continue to have a number of very significant reservations in relation to the NSFR standard, including the treatment of repos, derivatives and linked transactions. These treatments could have a substantial dampening effect on the liquidity of securities markets, especially equities, leading to increased volatility and higher transaction costs and reduced returns for investors. Moreover, it is also important to note that given the important role that banks play in capital markets, we need to ensure that the implementation of the new market risk framework (FRTB) does not lead to capital requirements that are disproportionate to the risk involved, especially regarding to some activities, such as underwriting, market-making and risk management tools, which we consider to be key components of the CMU. Furthermore, we believe that the Commission should review the treatment of intragroup exposures and recognise the EU, or the Banking Union

[9] AFME's response can be found here
[10] European Commission Communication on the call for evidence

at the very least, as a single jurisdiction. To facilitate cross-border capital and liquidity flows, the treatment of intragroup exposures should be properly revised[11].

Besides committing to conducting future reviews, we believe it is also important to reiterate some of our concerns raised with regard to the impact of regulation in certain areas. Despite these areas, as set out below, not being addressed in the Communication as published by the Commission in November 2016, **we believe that these should be picked up as soon as possible in forthcoming reviews of individual pieces of legislation or in future broader reviews of the regulatory framework** given their expected impact on the functioning of capital markets and financing of the economy or because of the fact that the changes required do not bring substantial changes to the content of legislation, but are merely seeking clarification of definitions used in the legislation.

There are broadly **two categories of issues that we would recommend the Commission to address in addition to the actions already announced in the November 2016 Communication**[12]:

- <u>collateral</u>: regulatory change is increasing the need for collateral, and yet at the same time certain regulations are placing a constraint on the circulation of collateral. Given the importance of collateral, these constraints should be minimised where possible;
- <u>definitions</u>: various definitions in regulations (e.g. in MAR) would benefit from being clarified.

Collateral

The use of high quality collateral has significantly increased as result of the regulatory reforms introduced seeking to make the system safer (e.g. EMIR, CSDR, AIFMD). Collateral is in high demand these days making it absolutely vital for the stability of the system as a whole to avoid any impediments to the free flow of collateral. In our response to the Call for Evidence we had suggested a few changes which could help in this regard:

- ***equities as eligible collateral:*** an unintended consequence from cross references in legislation that seems to have been created is with regard to the treatment of equities as eligible collateral. The Capital Requirements Regulation (CRR) allows equities which are traded on a Recognised Exchange to be used as eligible collateral. The definition of Recognised Exchange in Article 4(92) of CRR refers to the definition in Article 4(14) of MiFID. This cross reference has excluded ESMA from including non-EEA exchanges on its proposed list of Recognised Exchanges. We believe that this was an unintended consequence and would **urge the Commission to consider revisions to the Level 1 text to allow non-EEA exchange to be added to the list of Recognised Exchanges**.
- ***asset segregation regime:*** the AIFMD has set rules on asset segregation which require further clarification with respect to the segregation requirements down the chain of custody. Collateral management is an environment where beneficial ownership of collateral changes frequently. Requiring extensive segregation along the chain of custody would not work as there are frequent changes of beneficial ownership at the investor level. Forcing segregation along the chain of custody would *inter alia* reduce liquidity and undermine the fluidity of collateral throughout the EU. We therefore **recommend that the Commission provides clarity that full segregation is required only at the level of the provider of securities accounts to the fund, and that full segregation down the chain is not a mandatory requirement**. This would preferably be achieved by an amendment to the AIFMD Level 1 text.

[11] Further detail on our position can be found in our briefing note titled 'Free flow of capital and liquidity – issues for cross-border groups in the EU prudential framework'
[12] For more details on each of the issues raised, please read our more detailed submission to the Call for Evidence here

Clarifications of definitions and requirements

In our response to the Call for Evidence we identified various regulations which would benefit from certain definitions being updated. We would recommend these clarifications are being provided as soon as possible when regulations and directives are being updated. These proposed changes included:

- ***MAR*****:** there are a number of outstanding challenges in relation to implementation of the Market Abuse Regulation:
  - investment recommendations: feedback from clients suggests that the disclosures are not considered to add value, and we recommend that clients should be able to opt out of receiving such disclosures;
  - extraterritoriality: some of the provisions of MAR are drafted with extremely broad cross-border application, for example the investment recommendations rules, which technically apply to for example trading between a non-EU dealer and a non-EU client of securities of a non-EU company that are also traded in the EU;
  - suspicious transactions and order reports: there remain significant challenges in the surveillance of orders and quotes, particularly for voice trading, and there are not yet sufficient vendor solutions available to address this;
  - regulatory conflict: there needs to be a holistic approach to data, particularly from a cross-border perspective, as market participants are often bound by conflicting obligations, such as MAR (for example, insider list compilation), data protection rules, AML rules and employment law.
- ***SSR:*** we note that the Commission will assess the definition of the exemption for 'market making activities' and look forward to contributing to this important area***.***

CRR II impacts on functioning of the wholesale markets and risk warehousing capacity

Besides making sure that the regulatory reform agenda, which has been put in place in recent years, is fit for purpose and does not have unintended consequences, we believe it is important that the Commission and co-legislators remain conscious of the potential impact of additional pieces of legislation which will be adopted in the coming period. Probably the most prominent example of this is the CRD IV/CRR II package.

With regard to these measures we believe that although new regulation was essential to address key contributors to the financial crisis, the incentives created by CRR II have significant implications for capital markets activity and the leverage ratio (LR) in particular weighs heavily on low-risk assets like cash and government securities. These assets are used as collateral for central clearing and other financing transactions by market participants and as liquidity reserves by small and large banks. Thus, they play a critical role in the smooth functioning of financial markets. If market participants' ability to generate liquidity through these assets is impaired, or they cannot deposit cash with a bank that is constrained by the LR, particularly during stress periods, it will have negative ramifications to the functioning of financial markets.

While the NSFR and LR can be detrimental to the functioning of the essential plumbing system of the wholesale markets, the fundamental review of the trading book (FRTB) is likely to have a significant impact on the capital levels allocated against certain risks and activities. AFME is supportive of the FRTB's original objectives[13] and consistent implementation of the FRTB framework globally, but we believe that unless further calibration changes and other methodological issues are appropriately addressed in the framework, the FRTB could result

[13] The FRTB is intended to address structural shortcomings in Basel 2.5, including:
- Governance on internal risk transfers between the banking and trading book
- Development of a risk-sensitive standardised approach
- Factoring in market liquidity (i.e. introduction of liquidity horizons) and limiting diversification benefit across asset classes.

in a minimum 1.4- 1.5 times overall capital increase[14] - potentially rising to as much as 2.4 times if firms adopt broader use of the standard approach based on industry studies. [15]. Such an increase in capital requirements could have a detrimental effect on certain capital markets activities[16].

Given the FRTB governs the amount of capital that banks will need to hold against their wholesale market intermediation businesses, which provide end-users such as corporates, sovereigns and institutional investors with access to capital markets based funding, capital, investment and hedging solutions, it is crucial that the calibration of the framework is such that it does not have a disproportionate impact on availability of products and cost of intermediation that are integral to the functioning of EU capital markets and the real economy. If, as a result of disproportionate capital requirements, banks are forced to reduce intermediation, the reduction in market liquidity would result not only in higher funding and hedging costs for end-users, but also in increased market volatility and systemic risk as a direct result of fewer market makers and lower risk warehousing capacity.

Finally, the precise details of the single EU Intermediate Parent Undertaking requirement in the Commission's proposal for CRDV will need to be carefully evaluated to ensure that it does not result in any unintended negative consequences in relation to the ability of some non-EU banks to provide services to clients in the EU. While AFME has no position on the overall objectives of the proposal it is nevertheless looking forward to working with policymakers to provide suggestions that could decrease its burden on these firms.

To address these issues, we will make recommendations in our joint industry responses and CRR II position papers that should be adopted in the Basel Committee on Banking Supervision as well as in the EU rules to ensure that global markets continue to function and that end-users have access to risk capital sources across national and regional borders. Additionally, to improve the flow of capital across the Single Market, we will make a further recommendation regarding the EU specific requirements. These recommendations will be available as part of our work on CRD IV/CRR II.

[14] It should be noted that the FRTB's objective has never been to further increase capital requirements but rather to improve the overall design of the framework. The previous revision of the market risk rules, "Basel 2.5", had already addressed the capital issue by increasing the capital requirements significantly.

[15] BCBS report 'Basel III Monitoring Report'

[16] This is acknowledged by the EC, which in its impact assessment that accompanied the CRR legislative proposals, stated that *although the design of the prudential framework for market risks has been improved with the FRTB standards, **it could have a potential detrimental impact on the functioning of the EU financial markets via an excessive level of capital required** for certain product types that could lead to increased prices, reduced trading volumes and restricted access to capital market for certain actors of the economy*.

3. INVESTING FOR LONG TERM, INFRASTRUCTURE AND SUSTAINABLE INVESTMENT

Question: *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.*

3.1. Long-term investment

AFME's work on long-term investment has been led by the AFME-ICMA Infrastructure Working Group which comprises a wide range of experts in infrastructure investments and financing such as debt providers, equity investors, arranging banks, credit rating agencies and law firms.

After the financial crisis, the increased capital requirements for bank led to reduced lending capacity. In recent years, insurance companies and asset managers have answered the call for institutional investors to enter the market. There is now a vibrant and healthy pool of institutional investors. Any project which is well-structured and well-priced will have no problem being financed. Specifically, any project which is viewed as investment grade should have no problem being financed. An investment grade rating helps to broaden the investor base, as many institutional investors have a mandate to invest in investment grade assets[17].

Many but not all projects are able to be structured for achieving investment grade ratings, which many fixed income investors require. However, many new-build (greenfield) infrastructure projects carry risks that prevent them from achieving an investment-grade rating. Targeted risk mitigation, and better use of public sector resources, can help to make these deals more credit worthy. For instance, reduction of risk could be achieved when the procurement of a new road is made on an availability basis (paying for it depending on whether it is open and available rather than based upon on the number of cars or trucks that pay to drive down it (demand basis)), using CFDs (Contracts for Difference[18]) or similar methods to reduce or remove power market price risk. In particular, the power markets are very volatile and, without mitigation in some form, some transactions will struggle to be investment grade. This is especially relevant as the Commission and Member States seek to find ways to meet their climate commitments following the ratification of the Paris Agreement.

EFSI extension, pipeline of infrastructure projects and public authorities' education

The European Fund for Strategic Investments (EFSI) provided another and useful method for improving the credit of a project. Last September, the Commission proposed an extension of the EFSI from €315bn to €500bn by 2020. We welcomed the launch of the initial EFSI in 2015 and **strongly support a proposed extension in amount and duration**.

The EFSI helps to raise capital for projects that would have been sub-investment grade into investment grade ones. This is a positive use of public funds to facilitate investment. Indeed, it is crucial that public funds are used in this way, and not to "crowd out" private investment that would have happened anyway. In its evaluation report, the EIB found that 60% of investment potentially mobilised by EFSI comes from the private sector[19]. Those new investments could increase the GDP by 1.1% creating 1.4m jobs[20].

[17] AFME-ICMA Guide to infrastructure financing, 2015
[18] CFD, or Contract for Difference, is an agreement between two parties to exchange the difference between the opening price and closing price of a contract. CFDs lower the costs to developers of financing a project, by reducing exposure to volatile wholesale prices and reducing project risks. Under the CFDs, when the market price generated by an electricity generator is below a pre-agreed strike price, a "Low Carbon Contracts Company" (LCCC) payments are made by the LCCC to the generator. When the market price is above the strike price, the electricity generator pays back the difference to the LCCC,
[19] EIB independent evaluation report: EFSI on track to mobilise private capital, 6 October 2016
[20] EIB independent evaluation report: EFSI on track to mobilise private capital, 6 October 2016

However, despite an improvement of the European economy, private investments are still below 2008 levels: EU28 private investments were down from 22.5% in 2008 to 19.5% of the GDP in 2015[21].

A direct consequence of reduced private investments is the long-term decline in overall infrastructure spending in Europe. The Commission estimates that Europe requires an additional €1.5-2tn of infrastructure investment to meet its 2020 goals. The EIB considers that Europe needs to invest 3.6% of its GDP (€600bn all things being equals).

The EFSI extension is therefore necessary. However, the EFSI should be developed alongside further education to European local and regional public authorities about the public policy benefits of PPP transactions, as compared to funding through public funding. Most of infrastructure projects are ad-hoc initiatives which require a high level of expertise which local public authorities do not have.

In 2015, the AFME-ICMA Guide to infrastructure financing was published and was designed to help procurement authorities in the right choice of financing**,** the use of credit enhancement and ratings, the use of usage guarantees and the importance of post-closing changes.

European institutions, such as the Commission, the EIB with the EPEC and national institutions together with the private sector, could be **more visible in contacting and educating local public authorities throughout the EU** to understand their needs and provide adequate solutions (such as certain types of credit enhancement which many local public authorities might not be aware of). In particular, further education could be provided to public authorities to explain the specific risks that can be or cannot be transferred to the private sector to deliver value for money. Such education could be provided through local roundtables with the participation of both the public and private sectors.

The existing technical assistance programme under the coordination of a European Investment Advisory Hub (EIAH) is welcome and **should be leveraged to be more visible and reach more public authorities**, with the help of the private sector.

Mindful of the role of the European Investment Project Portal (EIPP), overwhelmingly, the fundamental bottleneck cited for infrastructure investment is supply and procuring the projects. There is no shortage of finance, but the significant shortage of bankable deals – plus competition for the deals there are available – is a challenge. However, creating the optimal conditions for infrastructure financing, may all serve to help stimulate the pipeline.

Solvency II considerations

We welcome the Commission's recent efforts to establish an infrastructure project asset class for which insurers benefit from reduced capital charges. This was a step forward to attract insurers to the asset class. However, there are four times more infrastructure investments in the corporate form which are out of scope[22]. **A reduction in capital charges for infrastructure investments in the corporate form would have a substantial impact in financing infrastructure and attracting more private capital into infrastructure investments within EFSI**.

We favour the application of the *criteria* for infrastructure project finance to infrastructure corporates, with appropriate modifications. We also support the extension of the *capital treatment* for infrastructure projects to infrastructure corporates. Where eligible infrastructure corporates ("qualifying infrastructure corporates") and infrastructure project finance entities have sufficiently similar risk profiles, applying the same capital treatment is justified. We consider that EIOPA's work refers to appropriate sources of information but we believe that for both equity and debt, the conclusions are overly conservatives and technical. In line with the broader Solvency II framework, EIOPA's focus is on price volatility. However, we believe that in this asset class

[21] Eurostat
[22] Moody's, Bridging $1 trillion infrastructure gap needs multi-pronged approach, 24 Feb 2016. On Moody's-rated European projects in 2012-14

broader questions of probability of default and loss given default are also relevant in the context of insurers' capital requirements.

Well-structured infrastructure projects have proved to be less risky than normal corporate credits, and should therefore logically require less capital to be set aside against them. For this reason, **we are supportive of ongoing efforts to review the calibration of risk charges for infrastructure corporates** and we will continue to contribute to the debate.

Procurement

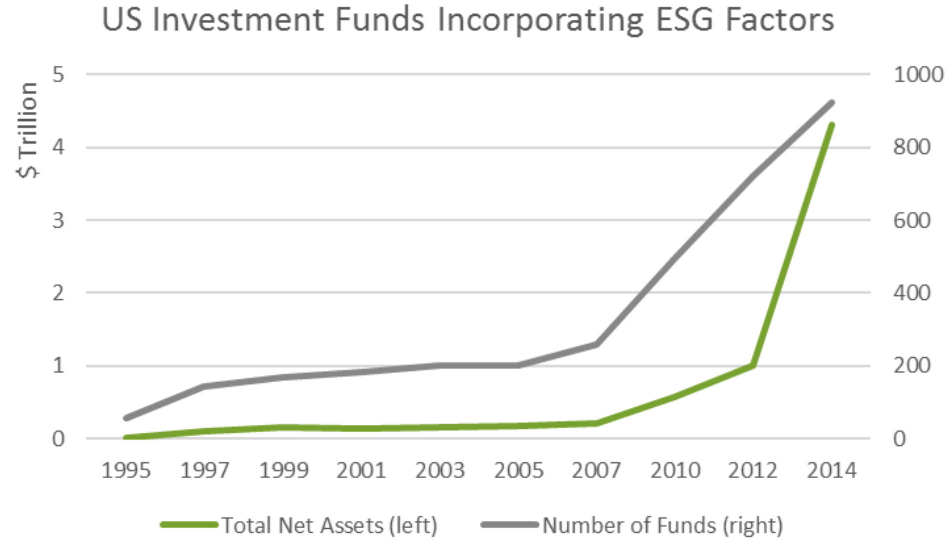
From the point of view of deliverability of funding, as well as to be able to ascertain relative value for money, it is important that a procurement authority secures committed financing at an early stage, which is not always possible in bond financing. In order to create a level playing field as between bond and bank financing for infrastructure, **we recommend a review of national procurement legislation**, in particular how the concepts of "deliverability of funding" and "value for money" are to be quantified.

3.2 Sustainable finance

AFME welcomes the Commission's focus on sustainable finance. The recognition of the Commission of the significant amount of investment that is required to shift to a low carbon economy is a first step forward in the right direction.

The size of the investment required is greater than the European public sector can provide alone. It is right therefore that the Commission recognises the role that the private sector can play. The Commission, Council and European Parliament's various papers give particular attention to the role of the investors, but as the Commission will recognise the banking sector has as a vital role to play, especially as key players in capital markets. It is imperative to remember the key role that investment banks play in capital markets in underwriting and structuring the deals that allow institutional investors' money to flow into projects.

The mobilisation of capital for green investment will follow the impressive wider trends in sustainable, responsible and impact investing (SRI), as **global SRI assets increased from $13.3 trillion in 2012 to $21.4 trillion in 2014**[23]. There has also been a significant increase in the last two decades in the number of funds incorporating ESG factors and their total net assets, with the values for the US illustrated in the graph below.



[24]

[23] Global Sustainable Investment Alliance (GSIA) – 2014 Global Sustainable Investment Review. http://www.ussif.org/Files/Publications/GSIA_Review.pdf
[24] Data from USSIF – Report on US Sustainable, Responsible and Impact Investing Trends 2014. http://www.ussif.org/Files/Publications/SIF_Trends_14.F.ES.pdf

The subject of climate change has quickly risen up the agenda of policymakers. Following the agreement reached at COP21, countries signalled their commitment to low carbon growth. Implicit within this is the importance of mobilising finance to support this transition. China has taken a leadership role in scaling up financing for sustainable development and made green finance a priority during its 2016 G20 Presidency, establishing the G20 Green Finance Study Group (GFSG). The Study Group's findings were published at the 4-5 September 2016 G20 Summit.

In Europe, the Commission is working towards the extension of the European Fund for Strategic Investments (EFSI) which could be linked to a greater number of sustainable projects through a 40% target of the investments under the Infrastructure and Innovation Window (IIW) contributing to COP21 objectives. The European Covered Bond Council (ECBC) is working on an initiative on Energy Efficient Mortgages that has the explicit support of the Commission.

CMU presents an opportunity to promote sustainable finance. CMU could promote the issuance of bonds and equities to finance green assets. The EU has the potential to play a leading role in building a sustainable finance strategy. For that reason, AFME welcomes the establishment of the Commission's High-Level Expert Group on Sustainable Finance (HLEG). It is important that market participants and sectors that may not be directly represented in the Group's membership can have opportunities to participate in the reflections and feed in their perspective. **AFME believes that the HLEG should consider how best to interact with the banking sector to ensure that the banking sector voice is heard.** The scale of the climate challenge requires all parties to be involved. **The EU should also look to work with the FSB Task Force on Climate-related Financial Disclosures (TCFD), to consider how best to improve disclosure of climate change related risks.** In December 2016, the Task Force published a report *Recommendations of the Task Force on Climate-related Financial Disclosures*, and invited feedback from stakeholders.

AFME has responded, through the Global Financial Markets Association (GFMA) and the Institute of International Finance (IIF), to the TCFD consultation paper. The key points raised in the response were the following:

- **We understand and support the objective of greater public disclosure of financial risks arising from climate change** and policy responses thereto, where material and relevant to the business of a given issuer. Such disclosures should, as intended, inform investors as to climate-related financial exposures to assist their investment and lending decision-making;
- **Disclosure should be made where material, but firms must continue to have the right to make judgments about what is material to their investors and creditors**, to avoid information overload or excessive disclosures that would rapidly become rote and of no value to users. This is essential to achieve appropriate balance and efficiency to support the intended use of the disclosures. It could be helpful for the industry to work with other stakeholders to develop guidance that would help firms make reasonably consistent determinations of whether climate-related risks are material financially to their businesses;
- **Scenario analysis will be an important foundation for any disclosures around climate-change risks**. A climate-related issue should be first determined whether it is material financially to an issuer, given its business model, balance sheet, and exposures. If the climate-related issue is not material, the issuer should be able to explain why it is not. If material, the issuer could proceed to second step: scenario analysis;
- **We support the concept of developing standard suggested climate scenarios and time horizons for climate-related financial disclosures**, but consider that further work would be required to make them useful and that, in any case, there would need to be **flexibility about how such standards are applied by each issuer** given its own facts and circumstances;

- We are concerned about the **suggested disclosure of internal carbon prices and propose that further work be done** to consider whether common price metrics or references should be developed;
- The response was aligned with the concerns of **asset owners** about the recommendations applicable to them: while they should consider the governance implications of their investments, t**hey should not be deemed in any way to have any formal or legal obligations to police the climate policies of their investee companies**;
- We generally support the goal of putting climate-related financial disclosures into mainline financial statements, but there will need to be evolution over time toward this goal, and **it must be clearly understood that the recommended disclosures are not intended to expand the otherwise-applicable scope of audit requirements or legal liability**.

4. FOSTERING RETAIL INVESTMENT AND INNOVATION

Question: *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.*

4.1 Pension reforms

Europe's pool of pensions assets is relatively underdeveloped when compared to the US, and is heavily skewed to a handful of Member States. The AFME BCG Bridging the Growth Gap report[25] showed that the US has around EUR 15tn of private pension assets, while the EU only has EUR 4.9tn. Of this EUR 4.9tn 75% resides in the UK, the Netherlands, Denmark and Sweden. In addition, of the investments that pension funds make in Europe, a much smaller proportion is allocated to risk capital/equity than in the US (37% vs. 53%). Growing the size of the pension funds and changing the allocation of their investments could significantly increase the total amount of investment available for European risk capital for high growth companies. A deeper pool of private pension savings will also be required to limit the strain on the public finances as population ages and old age dependency ratios continue to grow in Europe.

We note the work that has been undertaken in recent years by the Commission and EIOPA on the creation of a pan-European Personal Pension Product. We recognise that the introduction of a PEPP could improve the ability of citizens to save for their retirement. We therefore **support the creation of a single market for personal pensions** and a form of standardised PEPP noting the importance of prudential safeguards and a level playing field with other products available. Member States should be encouraged to consider tax breaks that could be provided to the PEPP.

To expand the pool of capital, Member States should consider the options for encouraging citizens to save additionally for their retirement. One of these options which **Member States and the Commission could look into is the use of automatic enrolment.** Under such a system, employers are required to put certain staff into a pension scheme and contribute towards it. This can lead to a significant increase of pension savings becoming available.

Important for the promotion of pension savings is regulatory certainty. Some countries in the EU have in recent years intervened in domestic pension markets. This has in certain cases led to the effective nationalisation of significant pools of private pensions. Such practices undermine the trust of retail savers in their pension system and hinder the development of pools of savings which can be invested through capital markets. Developing a legal framework to provide this certainty to savers is important and the **Commission could look at ways of providing support where necessary, for example through its recently established Structural Reform Support Service**.

We strongly support growing the size of the investment pool available from pension savings, as a source of both risk capital for SME job creation and for investment in other key sectors such as infrastructure and SME debt, amongst other asset classes. Member States and the Commission should **look at which instruments pension funds are allowed to invest in** and expand this range in a way that would benefit for example high growth companies. Examples from the Sweden and the US show how pension funds can for example get more involved in venture capital investments[26].

[25] AFME – BCG report 'Bridging the growth gap'
[26] AFME report 'The shortage of risk capital for Europe's high growth business', p. 49

5. STRENGTHENING BANKING CAPACITY TO SUPPORT THE WIDER ECONOMY

Question: *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.*

5.1 STS securitisation

The STS framework represents a unique opportunity to design a framework that benefits the economy and incorporates lessons from the financial crisis and we believe that the Commission's proposals represent a significant step forward in restarting securitisation in Europe.

However, several new proposals introduced during the debate, together with some unaddressed issues, which we discuss below, run counter to the objective to revive securitisation markets. Our members – investors and issuers – are deeply concerned that if certain provisions are not corrected in Trilogues then all securitisation – not just STS securitisation – could become prohibitively burdensome in Europe. In particular, **the following key elements of the STS framework** (including both STS Regulation and CRR Amendment) should be addressed:

- **Restrictions on permitted market participants:** originators/sponsors/original lenders and investors (Art. 2a) as well as on issuers (Art.2b);
- **Transparency Provisions:** an appropriate, principles-based disclosure standard for private transactions, including adjustments to the application of the loan-level reporting requirement is vital; investor name give-up will drive investors from the market;
- **Sanctions**: a "negligence/omission/intentional breach" standard should apply; the provisions to which sanctions could apply are numerous, new, and unclear; sanctions should be proportionate;
- **Risk Retention:** the retention level should remain at 5%; no evidence has been produced or impact assessment undertaken to support a change to the current regime; deviation from the global 5% standard would create major challenges;
- **Harsh capital calibration revisions proposed for the CRR**: we believe that the approach developed at international level does not adequately reflect the performance of European securitisations or the higher quality of future EU STS securitisations. Other trade associations may communicate further on this matter;
- **Third country issues:** the lack of clear provisions on the access of third country entities to the EU market as well as the requirement that originator, sponsor and SSPE must *all* be established in the EU for a STS securitisation (Council text) remains a concern;
- **Existing/legacy transactions and grandfathering:** the lack of provision for an adjusted standard for existing/legacy transactions, as well grandfathering provisions;
- **Conditions for the use of SEC-IRBA**: it is essential that the CRR Amendment allows for broader use of SEC-IRBA and includes provisions for the EBA to develop RTS for the use of a purchased receivables approach;
- **Grandfathering and general timing of application:** need to clarify that relief applies to positions in existing securitisations in general (not just those held at the relevant date), etc.

With issuance in Europe as low as EUR 237.6bn in 2016, of which only EUR 96.4bn was placed with investors, the European securitisation market remains moribund – largely because of the lack of a level playing field with similar fixed income products created by punitive regulation which does not recognise the strong performance of European securitisation through and since the financial crisis. With regulatory costs for holding securitisation paper several times higher than other similarly-rated products, participants continue to leave the market. Securitisation is already one of the most – if not the most – heavily regulated of fixed income products/financial tools, with the most conservative calibrations.

Therefore, for the new STS securitisation framework to succeed, it is vital that the provisions are carefully designed to ensure securitisation remains not only possible but also sufficiently attractive for both issuers and investors. It is important to look at the package of initiatives that impact on securitisation as a whole: a disproportionate or punitive requirement in one area will not be compensated by more flexibility in other areas. Picking apart individual components without considering their effect more generally will negatively impact the ability of both issuers and investors to restore the market.

We urge policymakers to consider amendments against these policy objectives. Provisions should be evaluated against their propensity to make a successful STS regime and a revived European securitisation market more, rather than less, likely.

5.2 Secondary market for distressed debt

The 2007-08 global financial crisis and the subsequent sovereign debt crisis had long-standing adverse economic consequences in Europe, including rising Non-Performing Loans (NPLs). Adverse macroeconomic performance increased NPLs but also persistently high NPLs have hold down credit growth and economic activity.

The continued high NPL ratios have affected bank profitability and capital build-up. However, notwithstanding the difficulties of legal and restructuring proceedings in some countries and limitations of unharmonized insolvency regimes for debt resolution, European banks have already put NPL strategies in place and actively manage NPL portfolios, including extensive reporting to supervisors. This is proven to be effective as shown in the downward trend in the cost of risk (loan loss provisions/average gross loans) for Tier 1 SSM banks over the past years.

Deeper secondary markets of NPLs, however, can contribute to accelerate the NPL adjustment process as banks continue internal workout towards restructuring their NPL portfolios.

The volume of NPL secondary market transactions continues to be low compared to the outstanding amount of NPLs, with around EUR 80bn in 2016 in market transactions[27] (against EUR 1tn of NPLs in the EU) with most activity traded in the form of NPL portfolio sales and to a lesser extent as NPL securitisations[28] (only EUR 155m issued in 2016). According to the EBA[29], since 2013, NPL transactions (including securitisation) were recorded in only 13 (CZ, DE, GB, HR, IE, IT, LV, NO, PL, PT, RO, SI, ES) out of 27 European countries surveyed.

The development of secondary markets of distressed debt has been analysed by policy makers, central banks and multilateral agencies like the IMF and the EBRD. The identified impediments for a more active secondary market have converged around six common themes, which include i) "poor" data quality of the assets behind the transaction; ii) quality of legal and insolvency frameworks (including limitations to a rapid execution of collateral); iii) subdued securitisation market; iv) lack of licensing and regulatory regimes to enable nonbanks to own and manage NPLs; v) tax (dis)incentives relating to transfer of NPL portfolios and loan loss deductibility; and vi) lack of economies of scale for small banks, heterogeneity of loans and role of AMCs in that context.

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[27] PwC estimates that in 2016, 2016 European loan sales accumulated €120bn of which around €80bn were NPL volumes. In 2013, total loan sales accumulated €64bn of which around €47bn were NPLs.
[28] AFME data. Does not include re-performing pools.
[29] EBA Report on the Dynamics and Drivers of Nonperforming Exposures in the EU Banking Sector (June 2016)

Among the proposals to develop the market, in 2015 the IMF suggested[30]:

- **Securitisation:** a more active involvement by the EIB/EIF through investing in senior tranches or providing guarantees on mezzanine tranches of NPL securitisation transactions;
- **Participation of non-banks:** facilitate licensing of non-banks for restructuring (or participation of non-banks in purchasing NPLs), which would lower the cost of entry into this market and allow for greater specialization; and
- **AMCs:** recognised the importance of AMCs to kick-start the market, although acknowledged that any public involvement should be compatible with state aid rules[31].

As stakeholders continue to propose a wide range of alternatives to develop the NPL secondary market, **we suggest the Commission to launch a public consultation to market participants and stakeholders seeking to identify best ways to develop this market**. The consultation can help the Commission in developing a strategy that establishes how the CMU project can contribute to facilitate the process of NPL resolution through market-based instruments. The consultation can also help as a diagnosis of the functioning of the market, provide evidence of possible existing market failures and evaluate the costs and benefits of existing policy proposals.

[30] IMF Staff Discussion Note (2015) "A Strategy for Resolving Europe's Problem Loans"
[31] Andrea Enria, Chairperson of the EBA, has recently put forward a proposal on a European AMC. Further information on this proposal available in: https://www.esm.europa.eu/speeches-and-presentations/esm-seminar-andrea-enria-eba-chairperson and in: http://www.centralbanking.com/central-banking-journal/opinion/2481794/why-the-eu-needs-an-asset-management-company

6. FACILITATING CROSS-BORDER INVESTMENT

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

6.1 Post trade

An efficient and safe post-trade process is a necessary requirement for a functioning capital market.

From the CMU perspective of allowing investors from all EU countries access to securities issued in all other EU countries, there is a particular challenge in giving such investors the ability to access the large number of post-trade financial market infrastructures across the EU.

National regulators play an important role in the design and operation of national post-trade infrastructures; in the past, national post-trade infrastructures were designed and operated from the perspective that the majority of investors were domestic investors; in a successful CMU, the majority of investors will be cross-border investors; it is critical that national regulators adopt this change in mind-set.

Given the reality of numerous infrastructures with diverging practices, intermediaries play an especially important role in allowing investors to access financial markets. It is critical that regulators and market infrastructures allow for the use of intermediaries, and ensure that regulatory measures do not create extra risk or complexity for investors holding securities through intermediaries.

There is an extensive agenda planned with a review of the Giovannini barriers due in 2017. AFME has been part of the European Post Trade Forum which has prepared a detailed report that is expected to be published in April 2017. An action plan which summarises the agreed issues and barriers will also be published. This plan will also propose actions and parties who will be responsible for delivering the solutions. We would **recommend the Commission and Member States to take forward the actions identified by the EPTF**.

The barriers identified in the post trade area are set out in much more detail in the forthcoming EPTF report, but worth highlighting are the actions required with regard to:

- **withholding tax**: inefficient withholding tax procedures create a barrier to cross border investment making the development of a genuine Capital Markets Union difficult. Current procedures which are different in each Member States lead to complex procedure for the collection of tax and processing reclaims where applicable. There is a lack of standardisation and consistency between different jurisdictions making it less attractive for investors to invest across borders. Member States have different tax relief structures with different responsibilities for different market participants. The Tax Barriers Business Advisory Group (T-BAG) has conducted important analysis into how the withholding tax issues could be resolved. It concluded that many of the administrative and efficiency problems could be resolved by no longer requiring the information on beneficial owners to be passed on through the custody chain up to the local withholding agents.

  We would **urge Member States to implement a standardised and harmonised system for tax relief at source and introduce simplified tax refund procedures**. If such actions cannot be undertaken by Member States, for various reasons, we believe that the Commission should come forward with proposals to harmonise tax *processes* introducing a common set of procedures, while recognising that actual tax collection and policy remains a prerogative of Member States.

  We have also identified challenges with T2S. Whilst T2S aims to harmonise European settlement, from a tax perspective it continues to highlight differences in local markets regulations. Each market has interpreted the T2S guidelines in light of their local rules, specifically in relation to market claims. The market claims detection period is 20 business days from record date under T2S. However, markets are approaching such claims independently and according to their own local regulations. Markets are choosing to deal with this by a mixture of gross debiting on payment date (Spain), waiting the 20-day period (Portugal), or following pre T2S process (Italy) with discussions still ongoing. The compensation payments themselves are subject to differing rules[32], and it would be helpful to have a

[32] * Spain – Post the Spanish Market Reform it appears that the market claim is a cash indemnity for a missed dividend hence not subject to withholding tax

consistent approach amongst the markets around whether a market claim is assimilated to a dividend or whether a market claim is an indemnity. We would **welcome harmonisation of fiscal *processes* for market claims;**

- **securities law reform:** at the moment, Member States decide about the ownership rights of securities and debt claims resulting in different approaches being taken. In certain cross border transactions this leads to uncertainty about the ownership rights of securities. Important aspects of dealings in securities are not harmonised at the moment, hindering cross border transactions and the development of integrated capital markets;

  To address this issue, which is explored in much more detail by the EPTF, we **propose the Commission to introduce a conflict of laws rule for all securities held through securities accounts** (subject to certain carve outs which might be necessary) and we look forward to continuing contributing to the work on this topic;

- **corporate actions:** the Level 2 legislation of the Shareholder Rights Directive II and its transposition into national law by Member States should be **consistent with the market standards for corporate actions processes and market standards for general meetings** to the highest degree possible;

- **measures to facilitate collateral management**: at the moment, collateral management is hampered by problems that fall into two basic categories; one category relates to restrictions on where and how collateral can be held; the restrictions may apply to the collateral giver or to the collateral taker, but have an impact on the collateral management process, and thus on both giver and taker; the second category relates to frictional problems (i.e. technical problem in the transfer of collateral from one location to another). Both categories of problem have the effect of forcing investors to hold securities used as collateral in a sub-optimal manner, and in some cases preventing the access to collateral management processes.

There are various other post trade areas where further action needs to be taken, including with regard to reporting requirements and registration. These issues are discussed in more detail in the already mentioned forthcoming EPTF report of which we support the conclusions and recommendations for actions. To make CMU a success, a well-functioning post trade landscape is vital and we believe that the **Commission and Member States should prioritise the actions proposed to reform the post trade area**.

6.2 ESA review

An important theme in the second half of the CMU project will be the funding and governance of the ESAs and we are supportive of a review in this area. We consider that the current institutional framework for securities markets supervision in Europe remains broadly fit for the EU28 but will need to be reviewed carefully in light of the UK's decision to leave the EU which could have a significant impact on the functioning of the ESAs.

Whereas prudential supervision has been harmonised in the Eurozone in recent years, capital market supervision in the EU remains largely a competence of national supervisors. In order to develop integrated capital markets, as aimed by the CMU initiative, we **encourage ESMA to focus efforts on supervisory convergence** to bring more harmonisation in supervisory practices and the Commission to support this process.

To promote supervisory convergence we would suggest to review the toolbox available to the ESAs and consider the need for new tools or enhancements as appropriate. It is also important to promote the appropriate interpretation of Level 1 texts and coherent implementation and enforcement of the ESAs' soft law mechanisms (e.g. guidelines, recommendations). As regards structures and processes, the leadership capacity of the ESAs, including ESMA, should be enhanced by strengthening their independence and executive capacity.

* Portugal – Post T2S post the 20-day detection period the recipient of the income (the seller) will be debited gross by the local agent and the income will be credited to the entitled party (the buyer) net of the WHT rate at which their account is set up. Except where the seller received the income payment gross of WHT, this will result in a net debit to the seller which can only be recovered by submitting a reclaim to the Portuguese Tax Authority via a process known as the Reclamação Graciosa

* Austria – Austria has changed the entitlements for dividend payments in line with T2S but the local tax authority maintain the old ex-date logic for tax reclaim entitlement

The forthcoming review of the functioning of the ESAs will be important to decide about the medium-term future of these institutions. We believe that **this review should take a two-step approach**. In the first step, the more immediate questions that could be addressed are:

- how supervisory convergence could be improved and the extent to which current supervisory structures should be enhanced;
- the funding of the ESAs.

The second step should take place when there is more certainty about the future EU-UK relationship. This would be an appropriate timing for deeper reflection on the functioning of the ESAs in the new political structure which will be in place at that time. During step two, further reflection should be given to:

- the institutional architecture and how the ESAs operate within the existing EU framework;
- the evolution of ESMA's role and powers post-Brexit including the ability to provide No Action relief;
- the role of the ESAs in the legislative process, particularly the extent to which input could be provided into the Level 1 process;
- the role of the ESAs with regard to third country equivalence issues;
- the role of the ESAs in international fora and in international cooperation.

6.3 Global context of CMU

We also believe that the Commission should emphasise the global dimension to Capital Markets Union. This element of CMU has not featured prominently so far but is crucial in attracting more investments to the EU and enable corporates to access global capital pools and funding opportunities. Therefore, one of the opportunities that CMU provides would be to facilitate European businesses' access to global capital pools and funding opportunities. CMU could help in making the EU a top global destination for capital investment. For example, non-EU securitisation should be eligible for STS recognition, and UCITS funds should not be unduly restricted from investing in non-EU assets. To increase the role of markets-based finance to European economic growth and job creation, the CMU should be firmly integrated in a global network with the United States, Switzerland Asia and other regions.

Important in this context would be to strengthen the framework for global regulatory coordination and ensure that a sensible equivalence framework is in place. Europe has the ability to play a leading role in the development of a coordinated and consistent global regulatory framework for cross border financial services. Conflicting regulatory policies and divergent implementation of global standards create barriers to capital flows and reduce market efficiency. There are also areas within the Commission's own competence where it can lead by example. Formal guidance should be agreed by the Commission with foreign regulators and provided to market participants on how equivalence and substituted compliance will work in practice. A pragmatic outcome-based approach for equivalence assessment, favouring regulatory dialogue and international supervisory cooperation, particularly as regards the timing of implementation of rules, should be developed, with a transparent and comparable set of criteria across all respective pieces of EU financial services legislation.

The EU will want to continue to benefit from maintaining access to pools of investment from outside the EU. With the expected departure of the UK from the EU, it becomes even more important to consider the external global dimension of CMU in the second half of the Commission's term. EU and UK capital markets have achieved a significant level of integration. While this has been beneficial for the EU28, it will become important post-Brexit for the EU27 to continue building up capital market infrastructure that is able to finance its economy, as long as new EU27-specific infrastructure does not decrease efficiency or increase costs for pan-European market participants. This capital market capacity serving the EU will need to be appropriately regulated with risks being monitored. Alongside this future EU27 capital market, the UK will remain a close and major international financial centre, and it will be in the interests of both the UK and the EU27 to cooperate in fostering growth and cooperation in their respective markets.

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