

25 June 2013

Mr Martin Merlin
Head of Unit, Financial Services Policy, Relations with Council
Directorate-General for Internal Market and Services
European Commission
2 Rue de Spa
Brussels 1000

European Commission Green Paper on Long Term Financing of the European Economy

Dear Mr Merlin,

The Association for Financial Market in Europe (AFME) is pleased to respond to the European Commission public consultation on the Green Paper *Long Term Financing of the European Economy*.

Further to our responses to the specific questions posed in the Green Paper, we have attached as a complement to this response: (1) the AFME Oliver Wyman report on "Unlocking Funding for European Investment and Growth: an Industry Survey of Obstacles in the European Funding Markets and Potential Solutions"; and (2) an AFME Briefing Note on the Role of Secondary Markets and Market Making in the Long Term Financing of the European Economy, developed specifically in relation to the themes and objectives of the Green Paper.

Yours sincerely,



Rick Watson
Managing Director
Head of Capital Markets

Consultation response

European Commission Green Paper on Long Term Financing of the European Economy

25th June 2013

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **THE LONG TERM FINANCING OF THE EUROPEAN ECONOMY**. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Executive Summary

This submission is comprised of three components. The first component is a major research report attached to this submission “Unlocking Funding for European Investment and Growth – An Industry Survey of Obstacles in the European Funding Markets and Potential Solutions” (the “AFME Oliver Wyman Report”, available on the AFME website at <http://www.afme.eu/unlocking-funding-for-European-investment-and-growth/>). The report provides detailed comments from a survey conducted by Oliver Wyman on the views of corporates (large, mid-sized and SMEs) as well as investors and banks as providers of funding. The content of the report, which also includes extensive research and statistical data, covers many but not all of the questions raised in the Commission’s Green Paper consultation. The second component of the response is AFME’s responses to the specific questions posed in the Green Paper submitted below. The third component is the AFME Briefing Note on the Role of Secondary Markets and Market Making in the Long Term Financing of the European Economy, developed specifically in relation to the themes and objectives of the Green Paper.

In summary, AFME members agree with many of the issues raised in the Commission’s consultation, as detailed below. However, we believe that further significant emphasis should be placed on the impact of the following on growth and investment:

- **The definition of long term investment needs to consider a wide range of instruments, maturities and participants.** This includes loans and other forms of financing provided by both bank and non-banks, as well as debt and equity investments, in both standardised and bespoke forms, which trade frequently as well as infrequently in the secondary markets.

- **Banks are continuing to and will continue to play the principal role in providing funding for corporates in the short, medium and long term spectrum in their dual role as lenders, as well as the arrangers and distributors of capital market investments.** According to ECB data, the overall amount of lending to European corporates provided by banks has remained stable, at EUR 5.6 trillion between 2007 and 2012. AFME members underwrite and distribute the vast majority of new debt, equities and syndicated loans distributed (€1.1 trillion in 2012) as well as provide secondary market liquidity.
- **We recommend that the Commission develops and continues to support a comprehensive legal, regulatory and secondary market architecture which provides businesses with the distribution channels needed by long term investors to access the instruments and secondary market liquidity that they need.** Long term investors need to have a healthy infrastructure of secondary market trading capacity in order to ensure liquidity, lower transactions costs, optimisation of their portfolios and to mark their portfolios to market. Many investors are required by statute, regulation or internal policies to only purchase investments which are deemed to be liquid. The adverse impact of a decline in liquidity tends to fall on less liquid instruments in particular, typically those related to SMEs and project finance¹.

We are cautious about the creation of a potential trade-off between long term behaviour and the important continuing need for strongly functioning mechanisms in the form of secondary markets trading strategies capable of aligning the differing requirements of investors and end-users in order to facilitate long-term funding for the economy as a whole. Market makers provide intermediary services that are critical to the fulfilment of the Green Paper's objectives. The range of market making activities forms an integral part of the market ecosystem and the intermediation chain leading to the allocation of capital from those who have it to those who need it or to the transfer of risk from those who are not specialised in hedging to those who are better prepared to intermediate and manage risk.

- **Certain regulations under consideration could have a material negative impact on corporates and investors, as well as EU competitiveness more broadly.** These include the proposed financial transactions tax, Liikanen and UK ring-fencing proposals, short selling regulation implementation, and MiFID II/MiFIR. Other regulations which are of concern, particularly to impacted corporates and some investors, is the impact of EMIR and mandatory margining on the structure and pricing of hedging/risk management services provided by banks, with acknowledgement that certain exemptions exist for non-financial corporations. Given the global nature of the financial sector, it is important to recognise that capital resources will tend to be channelled towards the most globally attractive investment environments and conditions.
- **The AFME Oliver Wyman report provides nearly 50 proposed solutions** on how to provide more flexibility to corporates by increasing the number of viable channels for sourcing financing, including private placements, infrastructure, securitisation, high yield bonds and real estate.

¹ AFME (2012). *Analysis of Fixed Income Trading Activity*
www.afme.eu/WorkArea/DownloadAsset.aspx?id=6821

TABB Group (2012), *MiFID II and Fixed Income Price Transparency: Panacea or Problem?*
<http://www.afme.eu/Documents/Statistics-and-reports.aspx>

Summary of the AFME Oliver Wyman Report

The goal of the report is to identify specific barriers and solutions to the challenges experienced by European corporates and investors in funding. The corporate respondents of the survey have combined revenues of over €400 billion; the investors have over €1.7 trillion of assets under management and the banks over €1.2 trillion of corporate loans outstanding. Overall, the report finds there is no single ‘silver bullet’ solution to funding growth, but it does identify specific targeted actions, each addressing a specific obstacle, which interviewees believe could achieve significant improvements. AFME members are keen to play an active role in making many of these proposed solutions happen; the report provides specific action owners for the proposed solutions. In terms of general themes, interviewees also cited two overarching constraints: the **macroeconomic outlook** as a barrier to growth and investment and the **unforeseen real economy consequences of regulation**. The challenges and solutions are largely specific to country, sector or product. For example, businesses in crisis-related countries and sectors such as infrastructure finance and commercial real estate have particular issues. The solutions will require coordinated actions across industry and public authorities. Some of the key findings of the report are included at the end of this response (see our response to question 30).

Further AFME Member Response to the Commissions’ Consultation Questions

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

We welcome the current focus of the European Commission towards encouraging sustainable growth and agree with many aspects of the Commission’s analysis regarding the characteristics and supply of long term financing, subject to our comments regarding the definition of long term financing under question 2 below. It is important to note that banking institutions provide a wide range of financing products both directly and arranged – short, medium and long term lending, as well as derivative and other hedging products linked to long term finance - to a broad range of types of borrowers – very large to very small. Financing of investment may take many different forms – loans, bonds, equities and hybrid instruments. Banks, through their wholesale markets divisions, also provide a wide range of secondary market services and products that are essential enablers for many non-bank investors to make long term investments.

The Green paper also correctly identifies the important role of self-generated investment by corporates, and the current situation of record cash balances held by corporates – indicating a lack of long-term investment appetite. This was a key finding in the AFME/Oliver Wyman report where concern over the macro-economic conditions was holding back investment.

As noted in the Commission’s Working Document accompanying the Green Paper, “..providing liquidity is an important function of secondary markets. Liquid and well-functioning secondary markets encourage investments in primary markets too, as this enables investors to sell their investments quickly and at low costs when needed.” We fully agree with this.

We believe that greater attention could be given to the importance of this theme in the Green Paper debate. Whilst it is important to examine ways to bolster the channelling of resources towards long-term capital and to incentivise long term behaviours, we note the important continuing need for secondary markets as a mechanism which enables long term investors to convert investments to cash so they can reinvest in other long term investments and/or realise the investment to pay out obligations. The ability to do this is essential to attracting funding into the economy in the first place. This should include all types of finance that can accommodate different investor and corporate needs. It is unhelpful to take a narrow and mutually-exclusive view of what constitutes long and short term funding and behaviour.

Properly functioning secondary markets will be instrumental in the fulfilment of the Green Paper’s stated aim to channel funding to address Europe’s long term capital needs. Secondary markets correlate funding providers’ (investors’) requirements for the ability to exit an

investment with users' (issuers') need for long term capital to achieve their financing objectives. They facilitate a way out of investments that are no longer desired without interrupting the funding supply of the issuer, thus also supporting market demand in the primary market.

Various types of investments targeted by the Green Paper tend to be less liquid, have maturities that extend beyond the business cycle, and are more exposed to changes in credit quality and inflation expectations. Market making is an essential mechanism providing liquidity for such investments. A market maker will absorb an investor's need for immediate demand or supply of an asset or financial instrument and charge a premium for the service provided. Clients can obtain quotes from several market makers for a particular asset or transaction which helps them to achieve better cost efficiencies.

Such liquidity provision is highly valued by investors because it provides the confidence of having a set of options to deal with unexpected circumstances. Market making services help investors bridge a range of gaps encountered in different market conditions, such as risk gaps, inventory gaps and time gaps. Mechanisms to manage such gaps are necessary in the intermediation chain to channel resources to growth-enhancing long term financing projects.

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

AFME agrees that it is important to understand what we mean by long term investment. We believe that there are two important aspects. First is the aspect which focuses on long-termism, ensuring an appropriate balancing of long and short term perspectives in the funding of economic activity.

Second, and also very important, is the aspect concerned with ensuring that there is enough short term funding available to the economy to support the long term objectives of the corporate sector. These two aspects are distinct but complementary. AFME recommends that the definition of long term financing be expanded to include all types of finance, since there is inevitably over the lifetime of a new company a sequence of financing techniques that a new business is likely to tap.

As noted under question 1 above, the role of market intermediation is essential to developing a full understanding of long term financing and the market mechanisms needed to support it. Intermediation in the form of market making helps to align the varying requirements of market participants, transferring risk to those better able to absorb it, helping businesses plan and cope with change and facilitating higher levels of economic activity. Market makers contribute to allocating capital to the most efficient investments within the economy and providing mechanisms for saving, risk pooling and management.

Market makers significantly reduce transactions costs in the economy – by for example minimising the costs for borrowers in relation to the number of savers that would otherwise have to be approached and to the variety of terms that they would demand.

Market makers play a key role in bridging the varying requirements – including time preferences, investment mandates and risk appetites – of investors (retail and institutional) and users of capital (corporates and consumers), which are often highly diverse. Many retail investors, for example, prefer their funds to be easily accessible, while institutional investors have a wide range of maturity preferences depending on their investment mandates (for example, money market funds, intermediate vs long term bond funds, loan funds, infrastructure funds, equity funds, emerging markets funds). Corporate borrowers also have a wide range of needs in terms of maturities (for example, bank working capital facilities, SME loans, construction build loans, infrastructure permanent financing, leveraged finance, and real estate).

We believe attention should also be given in the Green Paper debate to “shorter-lived” goods such as consumer assets. Capital markets access for consumer assets like vehicle and equipment loans and leases allow global manufacturing firms to support their businesses, expand production, create jobs and continue to make long-term investments in factories or machinery (which are long-term productive assets). Investment in consumer assets further supports manufacturing firms which contribute to the goals of sustainable and inclusive growth, job creation and enhanced competitiveness. It is the view of the Green Paper that investment in shorter-lived assets is “pro-cyclical” and that volumes would be “expected to recover as soon as the economy picks up”, however, new regulatory requirements will have serious consequences for real economy firms like auto and equipment finance companies’ access to capital markets regardless of the economic cycle. This will have significant implications, for example, not only for captive finance companies of auto manufacturers, but their parent companies, dealers and consumers they support worldwide.

3) Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

As mentioned by the Commission, banks play a major role in the euro area’s long-term financing. According to industry estimates based on ECB figures, the euro area Monetary Financial Institutions balance sheets (including insurance companies as well as banks and other financial institutions) amounted to € 34.50 tn as of Q3 2012, of which only € 8.5trn were long-term liabilities. Conversely, they owned nearly € 20.0 trn of long-term assets, meaning that they created € 10.5 trn of long-term resources in the economy.

The new Basel liquidity ratios, while sharply reducing banks’ ability to transform maturities, will unquestionably reduce the liquidity risk in banking balance sheets, but may also lead to an unintended effect which is a contraction of the global funding of the economy.

The preservation of the economy’s financing volumes becomes more challenging with a decrease in banking intermediation. Long-term financing comes, on the one hand, from long-term savings (which are channelled by capital markets, other financial intermediaries such as mutual funds, pension funds and insurance companies) and on the other hand, from short-term savings which are transformed into long-term credit instruments by banks. Moreover, banks, and banks alone, have money creation power permitting them to create *ex nihilo* new resources and hence, savings.

We do believe that banks in their roles as lenders as well as arrangers will continue to play a vital role in supporting long term financing, however the percentage of funding provided by non-banks is likely to grow in the future. Assuming the macro-economic outlook remains unchanged and banking regulation is implemented as currently expected, we believe the role of banks will evolve, depending upon the end “user” of the finance:

- **Large Cap and Multi National Corporates (MNCs)** across Europe typically have more limited reliance on banks for direct long term finance, with the bond and equity markets representing their primary source of long term core funding used to finance investment. MNCs may use direct borrowing from banks selectively for example when engaging in merger and acquisition activity or when funding a project on an arm’s length basis. However these are often refinanced in the public bond markets in due course. MNCs mainly rely on banks for backstop liquidity, revolving credit and working capital lines that may be partially drawn, but which do not form part of an MNC’s core long term investment plans. We believe banks will continue to provide these revolving and undrawn facilities and these will increasingly become the dominant form of primary bank exposure to many MNCs.
- For **Small and Medium Enterprises (SMEs)** direct borrowing from banks is the primary source of debt funding for investment. Given the relative accessibility of

financing from banks for SMEs versus other sources, and the concerted efforts by banks in some regions to support local SME investment, we expect banks to continue to play a pivotal role in financing for the SME sector. We also believe there is a role for banks in helping to bring third party investment in to SME lending which in turn will be used to fund long-term investment at the corporate level.

- Banks' role in providing direct long term lending for **investment in infrastructure** and other projects is likely to decline in the future, as new and planned regulatory requirements heighten costs to banks from both a capital and funding position. This is primarily driven by the long tenor (often over 10years) for which many of these projects require financing. Banks however are expected to play an active role in channelling and bringing alternative sources of investment into this market as they identify financing opportunities that are suitable for the investor bases that banks' distribution capabilities are able to tap.

As acknowledged in the Commission's paper, European long-term funding markets have traditionally been dependent on the maturity transformation provided by banks. This is demonstrated by the fact that European corporations currently raise a far greater proportion of their funding needs from the banking sector than via the capital markets compared to their US counterparts. Additionally banks will continue to provide direct finance for shorter-term construction phases of projects which are unsuited to institutional investors.

While the IMF (Oct 2012) expects the overall *balance sheets* of the biggest banks in Europe to shrink by \$2.8–4.5 trn or 7.3-12% of total assets through 2012 and 2013 as a direct consequence of the changes in regulatory requirements (particularly CRD IV), as previously mentioned *lending* by banks to corporates in Europe is flat from 2007-2012. In other words, the shrinkage in overall balance sheets has not impacted corporate lending activity as compared to pre-crisis levels.

We also note an important difference between the US bank model and the European model. Notably, the bank intermediation rate (over non-financial private sector debt) was 32% in the United States, compared to 78% in the euro area as of Q3 2012. This reflects an important difference in market structure. Other financial intermediaries (OFI) developed credit intermediation in the early 1980s. Government Sponsored Enterprises (such as Fannie Mae and Freddie Mac) and federal guarantees in the secondary mortgage market in general, are one of the key components of the American 'originate to distribute' model. By ensuring the liquidity of mortgage markets, they support lending and facilitate the removal of loans from bank balance sheets. In the EU, there is no equivalent to this sort of GSE. In 2012, in the United States, about 47% of mortgages passed through the books of Government Sponsored Enterprises (GSEs), which results in mortgage securitisation receiving significant public finance support. The GSE debt securities, are commonly described as "U.S. agency" obligations, which are perceived by investors to be implicitly guaranteed by the U.S. government despite explicit, legally prescribed denials in offering materials. In addition, the government holds \$821 billion in MBS issued by Fannie Mae and Freddie Mac, and the US Treasury also will provide up to \$274 billion of additional funds, if necessary. Given the current budgetary constraints in the European Union, such a government support is neither probable nor desirable.

There are continuing positive signals that corporates can at least partially replace bank borrowing with bond financing through their existing relationships with European universal banks or investment banking arms of third country institutions. Recent figures by Dealogic and JP Morgan reveal that high-yield issuance in European currencies are at their all time high and yields have dropped to historic lows, driven by mixture of reduction in the availability of low cost bank funding, low interest rate environment and investor demand for higher yielding investments. It should be noted that high yield bond issuance in the US is three times the level of European issuance according to data provided in the AFME Oliver Wyman report.

Receptivity by investors to this change is already occurring, although it could and should be accelerated through more proactive public policy debate on growth, and ways to further incentivise investors to purchase the types of funding products needed by corporates. The AFME Oliver Wyman report provides a number of specific barriers and proposed solutions in this area. However it should also be noted that banks will continue to be required by corporates of all sizes to provide through-the-cycle financing when market conditions may mean alternative sources are temporarily closed.

In relation to the provision of intermediation and market making activities discussed throughout this response, banking entities are well placed to continue to provide such client-oriented services to their corporate clients of all sizes. This is because such services are provided as part of an overall bank relationship with their customers, which cannot easily be provided by non-bank participants. Market makers place their own capital at risk and manage risk in the expectation – not always realised – that their risk management capabilities and ability to assess future client demand will help them achieve a reasonable return on their services. This is why, from a regulatory perspective, market makers have strong risk management processes and controls in place.

Structural separation of market making activity from deposit taking through a carve out of trading activities from universal banks would threaten the ability of capital markets to assist in meeting European financing needs. There is no guarantee that the reduced role of universal banks in capital markets will be compensated in the short and medium term by a higher capacity of viable stand alone entities. Mandatory structural separation may result in some banks withdrawing from market making activities on EU markets, for EU market participants, in EU securities and other financial instruments. The gap would be filled by other potentially unregulated entities that do not have to comply with similar restrictions. The result would be a balkanized funding structure that would rely primarily on domestic capital formation and concentrate risks within local banking systems. This outcome would be inconsistent with the objectives of the Green Paper.

The extent to which market-makers are obliged to assume risk as a result of their daily activities is closely controlled through limits and other measures and must be supported by adequate capital backing against the possibility of losses. The rigorous capital and liquidity requirements, as well as strong supervisory monitoring that banks are subject to provides assurance that such services are provided within responsible risk limits.

4) How could the role of national and multinational development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?

As noted in the AFME Oliver Wyman report, in Europe there is a considerable amount of development bank support already provided to SME and infrastructure investment. The amount of pan-European public support available includes a) EIB annual budget of approximately €60 billion/year for all types of support, with €12 billion/year allocated specifically to SMEs, plus b) €750 million by EIF in 2012, which can be expected to have an impact of €6.6 billion through expected leverage, plus c) possible usage of a portion of annual EU cohesion fund allocations of €49 billion/year. EU REGIO websites provide further details of the themes on which cohesion funds could be spent. Member states have discretion on how these funds will be allocated each year. A portion is typically spent on SMEs. All cohesion policy programmes are co-financed by the member countries, bringing total annual potential cohesion funding, including the national contributions, to €98 billion/year. These amounts are certainly welcome, but a question is asked as to whether these amounts are sufficiently large given the size of the EU economy.

We also note the growth of sovereign wealth funds in certain countries. Although these are not necessarily considered national and multicultural development banks, they can, due to their size, make significant investments. Also there is one aspect relating to bank long term financing which we are not sure can be covered by institutional investors and that is long term guarantees given by banks - EIB loans, projects, long term performance obligations of contractors and various forms of deferred payment obligations.

Institutional investors seek funded investments. In the past monoline insurers provided guarantees which could allow transactions to be placed in the bond markets. However, many of them are no longer in business. The AFME Oliver Wyman report recommends reviewing development of new infrastructure-only monoclones with a narrower product remit than pre-crisis.

For banks, these types of contingent obligations are not a funding issue (which is one of the main threads of the argument in the response to the Green Paper for why banks are reducing long term lending). Rather it is the issue of capital allocation tied up on a long term basis, lack of liquidity for the commitment (the beneficiaries' consents are required for transferring the risks and often this comes with minimum credit rating requirement, and need to cash collateralise if the guarantor's own rating falls below the trigger as we have found in the case of certain long term guarantees provided to the EIB).

Broadly, we believe that it is more a matter of refocusing the development banks' role, governance and access to funding or allowing some sort of collaboration between them on a pan- European rather than pure national level.

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

There are a variety of measures which support long term financing, while at the same time there those which strongly discourage long term investment through their impact on secondary markets. We actively support a wide variety of regulatory measures which help restore investor confidence and make markets safer, including an appropriate regulatory framework for market making activities that provides confidence to regulators and market participants and encourages liquidity and responsible risk management as well as investment in the real economy. We also support the activities of the Commission, EIB and EIF in providing pan-European support for SME and infrastructure transactions.

We are concerned however by what appears to be an emerging negative perception in certain quarters towards trading models based on market making and intermediation. A significant number of rules have been proposed, agreed or implemented over the past 2-3 years with the effect of restricting the activities of intermediaries in the securities markets. The cumulative application of these rules will significantly reduce, and, in certain cases, freeze liquidity provision in those markets. We have particular concerns in relation to the cumulative impact of the following regulations on secondary market liquidity.

Financial Transactions Tax: The impact of the proposed European financial transactions tax on secondary markets is a source of deep concern to the vast majority of participants, including from outside the financial sector. Although technically limited just to the eleven EU Member States under the enhanced cooperation process, the proposed tax will in fact apply to an unprecedented number of transactions in the rest of Europe and beyond. As currently formulated, the tax will increase the cost of raising capital for Europe's businesses and governments, as well as having a negative impact on hedging transactions undertaken in order to manage risk. Worst of all it will significantly impact the returns of long term investors such as insurance companies and pension funds.

Of particular concern is the negative effect that the proposed FTT will have on intermediation. The FTT proposal does not recognise the importance of intermediation in its design. Indeed, the

documentation accompanying the proposals appears to associate legitimate market-making transactions with business models that “only redistribute rents to the financial sector at the expense of the non-financial economy”. A variety of analysis on the negative impact of FTT has been completed by organisations such as EFAMA, BlackRock and the DAI.

Liikanen/Structural Separation: At this juncture, when traditional bank financing is becoming scarcer, AFME does not believe that the introduction of structural reforms that will further reduce the capacity of the capital markets, on which the growth of the European economy is likely to depend on in the future, is desirable and in fact will have an adverse impact on the real economy. We believe that the structural restrictions that are currently being considered are likely to reduce the efficiency with which financial services can be provided, materially increasing the end-user costs. As evidenced in our previous communications and consultation responses regarding structural measures, we conclude that the ring-fenced trading entities will need to drastically withdraw capacity, re-price, or consolidate, with major implications on market liquidity, competition, clients and systemic stability.

Short Selling Regulation: The interpretation of market making for the purposes of an exemption from the Level 1 short selling rules is posing unanticipated challenges to market participants. The problems relate to the Level 3 Guidelines published by ESMA in February 2013. The first problem concerns the prohibition on making use of the market making exemption in respect of certain instruments (and associated hedging of such instruments) which do not themselves create positions in relevant companies or sovereign debt for the purposes of the SSR disclosure regime – for example corporate debt and convertible bonds and rights. The second key problem is the narrow interpretation of “market making activities” resulting in the view that the exemption can only be used by market makers when carrying on market making activity in relation to a financial instrument that is traded on or admitted to trading on a trading venue – therefore the exemption cannot be used in relation to trading in OTC derivatives transactions. A considerable amount of activity where liquidity is provided (in particular for some sovereign debt and most sovereign CDS instruments) occurs away from trading venues as these venues may not provide enough liquidity, depth or customised offer to support all trading needs in large, bespoke and illiquid transactions.

As noted in the AFME Oliver Wyman report, many investors are of the view that the short selling restrictions in the sovereign CDS market have impacted the ability of participants to hedge country risk associated with corporate financing. It was suggested that after appropriate data is collected on market activity subsequent to the implementation of the Short Selling Regulation, ESMA does an impact assessment on the impact of crisis-related countries in particular and considers refinement of its criteria.

We also stress the importance of understanding the links between different pieces of capital markets regulation. In this regard, we note that the definition of market making included in the Short Selling Regulation was designed specifically for the purposes of that piece of legislation and should not be applied to other European or national initiatives for which it might not be appropriate.

MiFID 2/MiFIR: The MiFID 2/ MiFIR debate has the potential to enhance investor protection and market confidence, but if wrongly pursued could lead to an increase in spreads and trading costs through constraints in the provision of market making services. There are significant severe constraints under consideration for the proposed Organised Trading Facility (OTF) category. The deployment of own capital and the ability to conduct matched principal trading in an OTF is critical for the facilitation of investor business in equity, debt and derivatives markets. Without own capital deployment, client order execution on an OTF will be more difficult and more costly. AFME is also concerned by proposals to force instruments traded in the OTC space to trade according to non-intermediated models or platforms not designed for such trading. The OTC space covers the largest, least liquid trades – precisely the ones most in need of the support provided by market makers with a high degree of flexibility to absorb their more customised nature.

EMIR: Will substantially reduce counterparty credit risk and will make the OTC derivatives market far more transparent. However, central clearing and collateral requirements for uncleared trades will have some unintended consequences and will significantly step up the cost and complexity of hedging via OTC derivatives, impacting the return on investments for many end-users. Some amendments of detail of this reform will alleviate some of the end-user consequences.

On the positive side, regulation can have a significant beneficial impact. It is suggested that policymakers consider the use of various types of public support in order to achieve European industrial policy objectives. For example, in the area of SMEs, the “Unlocking funding” report highlights that SME funding is likely to need some type of public support for those SME loans which may carry degrees of risk beyond which lenders would normally not be willing to go. These can include both financial as well as non-financial mechanisms. Financial support includes direct cash support and guarantees as described in 4) above. Non-financial support includes other types of policy tools, such as capital charges by banks and insurers, as well as portfolio eligibility and asset allocation measures for fund managers and pension funds. Examples of capital charge tools include risk weightings for government bonds which at the moment are the same across Europe, irrespective of the significant variation in credit quality between EU member state governments. Another example is widespread implied support for financial products such as covered bonds, which include cover pool protection for investors under national legislation, favourable capital charges for bank and insurance company investors, and eligibility for certain covered bonds as assets in bank liquidity buffers under proposed Basel liquidity requirements. None of these benefits are currently available for other asset classes such as high quality securitisations (including SME, auto loan, leasing and other asset classes), but could be if policymakers chose to do so.

Other important example of non-financial public policy support is in the area of Solvency II on infrastructure, securitisation and other investment, which is described in detail in the AFME Oliver Wyman report. The calibration of asset/liability matching requirements, discount rate assumptions and other criteria will have a huge impact on investment behaviour by insurers. The calibration of IORP for pension funds, including pension fund asset eligibility criteria, will also have a very important impact.

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

Non-bank investment does and will continue to play an essential role in growth in the future. We believe institutional investors can bring new funding capacity provided that expected returns are sufficiently attractive. However, the body of investors is not homogeneous and investment preferences (equity vs. debt, investment horizons, etc.) will vary significantly depending on the investor. For any market to fully develop, standardisation is needed to enable investors to compare the relative value of investments.

In particular, it is important that non-bank institutions have the ability to invest in various forms of funding – not only securities, but also non-traditional assets, for instance loans. Many institutional investors lack of understanding/capabilities and mandate to invest in loans. In various European countries, the provision of cash is considered to be a banking activity, while in others it is not. Insurers, fund managers and pension funds need to be given the ability to invest in loans, even if they are not permitted under current national regulations to originate loans. A potential measure may be to consider the development of EU loan price/return benchmarks, and increase availability of information of loans and other non-traditional asset classes to inform investment mandates.

Institutional investors such as insurers and pension funds have significant capacity to provide infrastructure funding if various regulatory uncertainties and concerns are resolved. We address some of these concerns under question 7 below.

Solvency II is likely to incentivise insurers away from matching long term assets with long term liabilities, thereby increasing investment risk. Insurers are expected instead to focus on purchasing short dated and high quality bank debt - especially covered bonds, which will serve to reduce the ability of issuing banks to issue unsecured debt, and increase their asset encumbrance. At the same time, the liquidity and funding ratios introduced by CRD IV will be pushing banks to try to issue the longer dated debt that Solvency II is incentivising Insurers to avoid.

The same Solvency II incentives to hold shorter debt instruments apply to issuance from corporates, which will reduce the ability of insurers to play their traditional role as providers of long dated corporate financing. The bias towards higher rated debt will also reduce the likelihood of insurers lending to the sub-investment grade borrowers, and increase their propensity to quickly sell securities if a ratings downgrade occurs.

We know that CRD IV and associated measures are increasing the requirements on banks to raise loss-absorbing capital instruments. But the downgrades of bank ratings makes it far less attractive for insurers to hold bank paper under Solvency II. Insurers were previously the main source of this category of funding.

An effective cross-border recovery and resolution framework is crucial to ensure a well functioning financial market, where risks are appropriately priced, moral hazard avoided and national ring-fencing avoided. At the same time, if not correctly designed, the consequence of the Recovery and Resolution Directive (RRD) introducing overt "bail-in" measures over various categories of what was once seen as bank senior debt, will mean insurers may no longer be able to play a major part in this market - as many insurer investment mandates preclude or limit the taking of equity risk. Demand for securitisation assets (now requiring a similar capital charge to equities) is also likely to fall further hindering banks' ability to raise term funding.

For banks (especially deposit-based retail banks of the kind the UK Independent Commission on Banking (ICB)/Liikanen is encouraging), the interaction of the bail-in scope and the extent of Depositor Preference under the RRD, is likely to mean this class of unsecured wholesale debt (>1 month) will become much more expensive to access. If this is coupled with the possibility of a blanket requirement of a Minimum Requirement for Eligible Liabilities (MREL), banks are likely to be forced to seek additional long-term subordinated funding just to meet the MREL when, as described above, insurers are becoming less willing buyers of such notes.

Greater interconnectedness is expected to occur between banks and insurers as they are both likely to wish to hold substantial stocks of sovereign debt given new liquidity standards for banks and capital charges for insurers. This could create an irregular market and concentrated risk to sovereigns - with its associated volatility.

7) How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pensions funds, such as IORPS?

Insurers are well placed to invest further in long term corporate assets. However, the main barrier to increasing insurer allocations is the uncertainty caused by impending Solvency II regulations including capital charges, matching adjustments and the counter cyclical premium. Several issues were raised which may disincentivise insurers from investing in long term assets. These include:

Calibration of capital requirements: Solvency II relies on either standardised or internal model-based parameters to calculate capital requirements. The insurance industry, as well as the European Commission (via Jonathan Faull's letter to EIOPA dated September 2012) highlighted concerns regarding the current level at which parameters are set for financial risks, particularly for infrastructure finance, project bonds, securitisation and SME financing. If capital requirements overstate the risk associated with investing in certain asset classes, this will naturally create a false bias away from investing in those assets.

Narrow definition of matching adjustment to mitigate balance sheet volatility: Under the Solvency II proposals, assets are held on the balance sheet at market value, while liabilities are discounted at swap rates. While underlying interest rate changes will affect both assets and liabilities, changes in credit spreads will affect only the asset side, creating balance sheet volatility. For investments which are held to maturity, the change in credit spread does not necessarily affect the future asset cash flows (unless there is a default), and so this approach can lead to artificial volatility. Given that investors penalise volatility; this could disincentivise insurers from investing in long-dated credit assets (either loans or bonds). A matching adjustment approach has been proposed to align the discount rate applied to both assets and liabilities and thus reduce this volatility. However, there is concern that the current proposals have too narrow a scope and will not fully solve the issue. Moreover, the matching adjustment specifics are subject to member state discretion, which could cause inconsistencies across Europe, in conflict with the harmonisation objectives of Solvency II. Concerns regarding the finer details of Solvency II include:

- Funds cannot simultaneously qualify for the matching adjustment and the countercyclical premium, which poses a concern if the extended matching adjustment version is applied, whereby not all assets qualify for matching adjustment.
- Further, there are concerns about how the counter-cyclical premium and matching adjustment will be applied to businesses outside Europe. There is an argument that EU based insurers should be permitted to take credits for matching assets on non-EU balance sheet.
- Extrapolation of data beyond last liquid point (LLP) opens up the risk that markets will put in place artificially short LLP to benefit balance sheet view. This could lead to inconsistencies between the curves used for assets and hedges.

Solvency II was originally proposed in 2009, but has been subject to multiple delays and is not yet finalised. This creates uncertainty for insurers and has caused some insurers to delay making investments in new long term assets until the regulatory treatment is clarified.

In the development of the IORP Directive, the European Commission and the European Insurance and Occupational Pensions Authority (EIOPA) should act to remove regulatory uncertainty and ensure evidence-based calibrations are used specific to pension funds. The potential extension of Solvency II to pension funds should reflect the different risks borne by different stakeholders. Returns for pension funds are critical to providing sufficient pension pots for customers. Thus, any regulation that increases costs or restricts pension funds' ability to hedge risks should be considered carefully.

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

Although pooled investment vehicles already exist in various forms (through securitisation, for example), existing and proposed regulations do not necessarily encourage investment in securitisation based on misperceptions of risk which are based mainly on US subprime.. These

types of risks have been already significantly mitigated through EU mandatory retention requirements, CRD 3 trading book capital charge changes and other changes. The industry welcomes initiatives to increase the menu of options available for pooled investment vehicles, including the concept of a new type of fund to invest in illiquid instruments. For example, loans are currently not permitted as eligible investments in UCITS. The AFME Oliver Wyman report covers this topic in more detail.

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

As previously mentioned, there are two separate means of banks being able to raise cash for their corporate customers – as lenders and other services such as transactional banking, and also as arrangers, distributors and market makers to capital markets investors. While important to introduce liquidity regulation, two standards² developed by the Basel Committee for funding liquidity will limit banks' ability to lend. Altogether, holding long-term assets will be penalised by the necessity to hold so-called liquid assets (mostly sovereign debt and deposits to central banks).

Modifications brought in January by the Basel Committee notwithstanding, the liquidity rules would have a potential negative impact on bank's funding as well as the financing of the European economy. The bank balance sheet deleveraging observed since August 2011 is the consequence of the growth recession as well as an anticipation by banks of the negative impact of this ratio on their activities.

European banks have started scaling down and/or reorienting their activities. In particular, medium and long-term financing activities with long maturity or low profitability are reduced, as these are very costly in terms of liquidity and funding under the new requirements. This includes activities such as mortgage lending, lending to SMEs, lending to public entities such as municipalities and infrastructure investments (project and export finance). For example, it will be far less economically viable for banks to finance large scale infrastructure projects. This situation is at odds with the European 2020 strategy to achieve a smart, sustainable and inclusive European economy and detrimental to long-term investment.

There must be room for maneuver to avoid that the financing of the European economy by banks is further scaled down. To cope with the predominant financing of the European economy by banks, high quality assets that are eligible to central banks (consumer credits, residential loans, corporate loans) should be recognized as liquid assets. This would be closer to the American situation, where around 50% of outstanding mortgages are refinanced thanks to the US government-sponsored enterprises (Fannie Mae, Freddie Mac). It would also mitigate the current inappropriate situation where the monetary policy of the European Central Bank is inefficient (since large amounts of money are deposited in Central banks to build up liquidity buffers instead of financing the economy). This process has been highlighted by the long-term refinancing operation (LTRO) that the ECB has set up to inject long-term liquidity into banks, liquidity that came immediately back to the ECB in the form of deposits. Due to this excess liquidity, monetary policy becomes less efficient, as the ECB can only decide to sterilise a large quantity of this liquidity.

To allow a balanced financing of the European economy (i.e. a progressive decrease in bank financing and a parallel increase in the financing by capital markets), the Commission should ensure appropriate features in the delegated act to implement the LCR that it will publish no later than June 2014. This should permit high quality assets in banks' liquidity buffers that are eligible to central banks and which represent sound financing of the real economy.

² The Liquidity Coverage Ratio (LCR) is set to regulate banks on their short run liquidity management. In parallel, the Net Stable Funding Ratio (NSFR) is set so that banks will better match the maturity of their resources with the maturity of their assets.

Concerning the Net Stable Funding Ratio (NSFR), the observation period (which is set to last until the end of 2017) should be fully utilised to review unintended consequences on corporate financing. In the current set-up, this ratio would have serious implications on banking business models. It would strongly reduce the transformation capacities of banks and limit their credit intermediation role. Indeed, the long-term ratio would in particular imply that each euro lent to a company via a one-year credit will be covered by a euro of resources over a year. Moreover, this ratio will encourage banks to limit this euro of long-term resource to activities other than credit to the private sector, as this euro of resource would also be permitted to finance either € 20 of government bonds, or between € 2 and € 5 of corporate bonds.

From the corporates' perspective, as described in more detail in the AFME Oliver Wyman paper, many large and mid-sized corporates could benefit from a European private placement market. In the US, approximately \$50 billion/year is raised through well-developed regulations such as SEC Rule 144A and Rule 4(2) private placements. These programmes enable US investors to purchase securities and loans. The Rule 144A programme is particularly popular since it enhances secondary liquidity by restricting resales of the private placements to qualified institutional buyers (QIBs). This enables corporate issuers to tap markets more quickly with more flexibility. On the other hand, European investment regulation is largely centred around the difference between listed and unlisted securities. This distinction does not help investors identify liquidity, since a listing does not automatically make a security liquid.

In the field of SME lending banks are likely to continue to be the major originators of these loans due to the loan characteristics – small and variable balances, and local customer relationships, although additional non-bank capacity is welcome. Increased capacity to issue SME securitisations by banks would provide a significant boost to SME lending capacity. Many banks already provide significant amounts of SME loans to credit-worthy borrowers. However, there are many SME borrowers who do not meet bank credit criteria particularly in crisis affected countries. For these types of loans in particular, some type of public policy support will be required to restore the economic viability of SME securitisation to banks. Increased use and capacity for the EIF mezzanine guarantee programme and other guarantee programmes is one of the most efficient ways of providing additional capital for SME-specific lending. To lower the cost of SME securitisation financing, spreads also need to be reduced. The ECB's recent announcement that they are consulting with the EIB and Commission on possible ways to restore SME securitisation is welcomed by the industry.

10) Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicity of aggregate long-term investment and how significant are they? How could any impact be best addressed?

The Consultation highlights the potential tension between the pursuit of financial regulatory reform in EU and the drive to encourage long term investment by the financial sector. Significant reforms to the capital and liquidity requirements for banks have already been introduced. While welcome in many respects, these could have significant implications for the incentives to invest in less liquid instruments. We appreciate that the Commission has noted that the potential cumulative impact of prudential regulations could impact long-term capital formation. The regulatory bodies that have recently implemented or proposed new regulations have not made available an assessment of cumulative impacts of these regulatory reforms on the real economy. We fear the sweeping changes across the landscape of financial regulatory reform results in layers of overlapping requirements that, left unaddressed, will have significant unintended consequences and will reduce liquidity and availability of credit across global markets. One example is inconsistent international definitions of risk retention on securitisations, and a lack of mutual recognition, which will inhibit issuance and investment. More broadly, one of our key concerns is that regulators have not undertaken a cumulative

impact of the varying proposals, by which they would be tasked with assessing the combined impact of regulation on the financial industry as a whole.

We believe that the core elements of the European reform of the banking sector are addressed in prudential reforms included in the CRD IV, Banking Union and Bank Recovery and Resolution Directive packages. These reforms are having a stabilising and transformational effect on the industry and the financial system. For this reason, we believe that EU authorities should not press forward with further prudential regulatory reform – at least until these reforms are implemented and the cumulative impact has been comprehensively assessed. As highlighted elsewhere in this consultation response, regulatory uncertainty is a key factor inhibiting long term investment behaviours.

Cumulative impacts could best be addressed by requiring the regulatory bodies to work together to assess potential impacts before regulations or frameworks are made available for consultation (for example, the recent BCBS Securitization Framework Consultation was released before a Qualitative Impact Study had been completed). New regulatory requirements, like the securitisation framework, will have serious consequences for real economy firms like auto and equipment finance companies, who rely on capital markets for funding and liquidity, and their parent manufacturing firms. Regulators did not fully consider the impact of regulations on the real economy or concerns related to economic growth. Instead, they focused on the lowest common denominator (e.g., subprime mortgages) with little regard to the underlying quality of the assets or soundness of the structures. The result will be fewer vehicle and equipment sales, higher costs for consumers and dealers and lower overall economic activity.

The ongoing regulatory programme will not only continue to drive structural change amongst the banking industry without the need for additional intervention but will significantly reduce both the probability and impact of individual bank failure and the overall level of systemic risk. The Bank for International Settlements calculates that an increase in equity capital ratios to 11%, combined with implementation of the liquidity ratios, will significantly reduce the probability of a systemic banking crisis. As we have noted above, the regulatory requirements come at a material cost to end users of financial services and also reduce the availability of financial intermediation.

Thus, considering that the likelihood of failure has been materially reduced through the Basel III/CRD IV reforms, other ongoing regulatory reviews and that it will take a while for banks to readjust their business models to the current regulatory framework as well as to the tough commercial environment, we believe that there should be a “regulatory pause”, a period of observation, to analyse the cumulative impacts of the regulatory reform agenda and what the impacts are to the availability of long-term funding.

This conclusion is shared in Deloitte’s recent Bank Survey (2012), which reveals bankers’ expectations that reform will be a lengthy process and re-sizing the industry will be achieved through a combination of natural run off, divestment and balance sheet constraint. Therefore, market driven changes need to be given time to run their course without further intervention in banking structures which is both unnecessary and likely to impair the ability of banks to provide cost effective financing support to their customers and the wider economy.

As mentioned above in the answer to question 3, it is inevitable that the cumulative impact of reforms will be to reduce the capacity of banks to provide the same level of financing for long term investment as hitherto even when the deleveraging process referred to above has run its course. Much of the cumulative impact of regulation has been directed to ensuring that banks are not too big to fail in an orderly fashion (or to be rescued). Additional capital buffers are being imposed on systemically important global and domestic institutions while this may be complemented by further requirements to meet perceived systemic risk. Put simply the cumulative impact of regulation has been to impose a penalty on size, thus discouraging balance sheet expansion by international banks..

Careful consideration should therefore be given to the implementation of additional capital requirements for domestically systemically important institutions as, to the extent that these are not part of large cross-border banks, it will be precisely these institutions that may have to make up for a reduction in lending by their G-SIB peers.

It might also be helpful to consider providing capital relief for longer term lending which is appropriately funded and secured in order to make the economics of such business more attractive to bank lenders. As is described in detail in the AFME Oliver Wyman report, the EIB, EIF and European Commission already provide various types of guarantees, some of which can be used by banks to provide capital relief on targeted types of transactions.

Given the structural change currently on the way and the cumulative impacts of regulatory reform, AFME has highlighted in its response to the structural reform consultation the beneficial aspects of diversity in the European banking system. This is in terms of business models, banks' geographical footprints and availability of funding products and the risk that these would be undermined by any attempt to introduce one-size-fits-all structural solutions. AFME also noted that any such interventions were likely to have suboptimal outcomes and risk inhibiting further the development of a single market in financial services, exacerbating the threats to the European economy from fragmented, but nationally concentrated markets. This is especially in the context of cyclicity as less diverse deposit banks and narrow-scoped trading entities are less likely to be able to absorb losses from one business line with profits from another, thus reducing availability of through-the-cycle financing.

11) How could capital markets financing of long-term investment be improved in Europe?

We discuss a number of potential measures under questions 10-14 and 26-30.

As previously mentioned, it is clearly important to revitalise capital markets and improve their capacity to lend to the real economy in the new funding environment. Achieving such a shift will require new funding models, new sources of investment, and supportive policy. In particular, it will be important to deliver greater scale to develop market capacity. While the private sector needs to develop new funding models – such as bank / bond hybrid structures – some of the necessary change can be delivered through public policy – including:

- Greater emphasis on market making, as described below;
- Greater deliverability and consistency, through a stronger pipeline of projects, helping to make the process more efficient and more predictable;
- Given the demise of monoline insurers, new methods of delivering credit enhancement, building on the EIB's Project Bonds Initiative, to create a more attractive investor proposition, particularly during the riskier construction phase;
- Opening up procurement to bank / bond hybrid solutions;
- Better calibration of prudential rules;
- Achieving greater consistency in, or harmonising, national procurement frameworks, to deliver greater transparency and predictability for investors. This is particularly important given the estimated 80% of pension assets and 70% of insurance assets are held outside Europe.

In order to improve long-term investment in Europe, investors from rich funding countries outside Europe will need to be attracted. International harmonisation and cross-border dialogues between regulators will be key in developing a global level playing field, whereby the free flow of capital is promoted.

Market financing will be an increasingly important complement to traditional bank lending. The challenges explored in the Green Paper show that intermediation in secondary markets is needed more than ever to foster the supply of long term capital. As noted in the Green Paper, ensuring effective and efficient intermediation channels for long term financing is a complex and multi-dimensional task. AFME research has shown that the adverse impact of a decline in liquidity tends to fall on less liquid instruments in particular, typically those related to small and medium enterprises (SMEs) and project finance – precisely the types of investment highlighted in the Green Paper³.

It is therefore critical that a number of market activities beneficial to the economy and the intermediation chain are not unduly restricted through regulation. In particular, the important role played by market making in aligning the varying requirements of participants needs to be encouraged. A significant number of rules have been proposed, agreed or implemented over the past 2-3 years with the effect of restricting the activities of intermediaries in the securities markets as described in question 5) above.

12) How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investors, better support the financing of long-term growth investment in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?

While banks have traditionally provided long-term financing, the post-crisis regulatory environment has restricted their ability to do so and capital markets will have to fill the gap created by the growing demand for long-term finance. Capital markets are momentum driven: successful issuances allow companies to raise debt at cheaper levels; and strong market appetite can be demonstrated by an increase number of issuances. For example, the proportion of the shares and other equities as a percentage of gross value added is higher in the United States than in the euro zone and the equity gap has been widening over the last twelve years (345% in 2012 vs 353% in 2000 for the United States against 272% in 2012 vs 288% in 2000 for the euro zone).

Policymakers can take actions to: 1) incentivize/mandate increase household saving and enable flows into equities; 2) reduce tax biases against equity (tax codes often make interest payments cf. dividends tax deductible); 3) reduce management incentives against equity (performance metrics, esp. those based on EPS or ROE, create incentives against equity); and 4) promote access to equity markets for smaller companies, e.g. by: increasing amount of money that can be raised through ‘mini IPOs’ with lighter registration requirements; providing tax credits for registered ‘angel investors’ that fund early-stage start-ups; legalising ‘crowd-funding’ on platforms outside exchanges; and encouraging regional exchanges that rely primarily on local investors to provide capital for local corporate too small to list on major exchanges.

Taking into account European investors’ appetite for liquidity, introduction of incentives for companies to distribute dividends in the form of shares rather than in cash could be an

³ AFME (2012). *Analysis of Fixed Income Trading Activity*
www.afme.eu/WorkArea/DownloadAsset.aspx?id=6821

TABB Group (2012), *MiFID II and Fixed Income Price Transparency: Panacea or Problem?*
<http://www.afme.eu/Documents/Statistics-and-reports.aspx>

interesting means to consolidate shareholders' equity and to provide financing without increasing corporate indebtedness. Finally, this suggested mechanism could encourage companies to reinvest more in long term projects through self-financing solutions, while at the same time reducing the observed equity gap.

The market for private placements could be expanded. Standardisation of documentation, ratings, publicly available data and disclosure would be important to facilitate issuance. Banks will play a crucial role in matching financing needs and investor demand among their client network and making sure that they provide a secondary market in case investors want to step out of their investments at a later stage.

Also the high-yield bond market could be further developed. Recognizing the risks involved in this market, adequate information regarding high-yield investments and disclosure will be key to enable long-term investors to make well-informed investment decisions. Furthermore, it will require insolvency regimes to be harmonized, and also engagement from market makers to provide secondary market liquidity.

We would add that if new products or markets are developed to stimulate funding, it is essential that new savings are attracted. Otherwise, existing savings will only be substituted without creating new financing.

Finally, we note that the secondary market can play an important role in providing incentives for investment into mid-cap firms. Mid-cap shares tend to be less liquid given the perceived higher risk they carry. The services provided by market makers will be important in aggregating liquidity and therefore increasing the willingness to invest in these stocks.

Benefits of a New Originate to Distribute (OtD) model

It is important to recognize the many benefits associated with the OtD model. Regulators and market participants acknowledge its importance to get the real economy back on track. OtD, when properly managed and subject to active management controls can play a crucial role as a flexible and alternative funding channel, complementary to credit provided by banks in their traditional role as corporate lenders. For borrowers, the OtD model will be crucial in funding their activities going forward, especially in sectors that need long-term financing like infrastructure, real estate, and project finance.

For banks, the OtD model is a valuable tool to respond to the funding needs of their customers. Banks can continue to provide financing to the real economy while actively managing the capital allocated to client positions. OtD secures the commercial relationship that banks have with their customers.

For investors, OtD offers alternative investment solutions. Depending on the structure, investor protection can be enhanced via the use of collateral, guarantees or other credit enhancers. OtD offers the flexibility in the sense that payment streams can be structured to meet particular investor requirements. At the same time, banks will be able to offer further services in the secondary market via their fixed income platforms.

Even though securitisation is a powerful financing instrument, we notice that placed issuance volume is still declining although at least part of this decline, which has also occurred in covered bonds, is due to central bank funding availability. Taking these concerns into account, the OtD model will be geared towards securitisation in a more simple form, focussing on more transparent, easy to understand structures. Although the OtD model is fundamentally sound, the industry agrees that attention must be paid to specific asset classes and structures that caused problems in the crisis such as US subprime and CDO squared, which rightly have been a focus of regulation to avoid a repeat of those problems. Next to that, the distribution of plain vanilla instruments (i.e. loans in their original form) will become more widespread. Other new developments within the OtD landscape are seen in the form of the loan funds, co-lending agreements between banks and investors, and consortia backed by banks funding multiple

projects. Non-banking entities and institutional investors are seen entering in the market, competing directly with banks in the field of loan origination.

Nevertheless, banks cannot rely extensively on collateralised funding to finance their credits. Encumbrance levels will more and more be monitored closely by regulators. Limits in term of collateral utilisation as a percentage of total assets or specific assets are already included in some national covered bonds laws, like in Australia, Belgium, and Canada. Greater harmonisation between national laws could boost the market even more, one of the examples being the level of information required for the collateral pools or the frequency of reporting.

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

Although our members have considerable expertise in covered bonds, AFME has focused this response on other products and issues. We would be happy to provide more detail to the Commission if requested on covered bond issues.

14) How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?

We fully support efforts to “reshape” securitisation markets to unlock sources of finance as it has been a critical tool in facilitating cost-effective credit globally. We are becoming increasingly worried that recent regulatory efforts to reform securitization markets will apply such punitive capital requirements to high-quality assets it will make them unsuitable for retail or wholesale investment. For example, the regulatory capital approaches put forth in the BCBS Securitization Framework Consultation can result in capital requirements that are over ten-times present levels for prime auto and equipment securitizations, despite the fact that these asset classes performed before, during and after the financial crisis. In addition, the present proposal is poorly calibrated resulting in higher capital requirement for a triple-A rated securitization exposures supported by credit enhancement than an unsecured single-A corporate loan to a non-financial company with no credit enhancement. (See vehicle and equipment issuers’ letter to BCBS: <http://www.bis.org/publ/bcbs236/viwig.pdf>.)

While balancing stability and growth, securitization markets should be considered an effective method for corporates and financial institutions to free up capital which can be mobilized for additional lending. We agree that simple securitization products can be effective for improving maturity transformation. In order to kick-start securitization markets, regulators should balance regulatory requirements with the underlying risk of the securitized assets. We are optimistic that regulators may recognize efforts such as the Prime Collateralised Securities (PCS) quality label which is intended to promote transparency, simplicity and standardization throughout the asset-backed market. Regulators should not treat all securitizations the same, rather a delineation should be made to acknowledge prudent structures from less desirable structures such as leveraged transactions backed by assets where the originator carries no retained interest in the transaction. Most of all, the industry will welcome a visible, coordinated and forceful signalling by policymakers (ECB, European Commission, FSB and others) that investment in high quality securitisation is encouraged, through visible steps. Notably, during the crisis the ECB’s large purchases of covered bonds in the secondary market provided a visible and effective signal to the market that the ECB supported covered bonds as a product.

We note the work that the Global Financial Markets Association (GFMA, an affiliate of AFME) has been submitted to the Financial Stability Board regarding shadow banking. Broadly, GFMA believes that shadow banking can contribute positively to the financial system by providing

significant funding to capital markets and thus the real economy, and by diversifying risk in the financial system. We would be concerned with any presumption that shadow banking is inherently bad for financial stability and do not believe that activity in the shadow banking system per se should be discouraged. We consider that any proposed regulatory measures that the Commission considers with regard to shadow banking should be:

- the product of a detailed impact and cost-benefit analysis mindful of the interaction with and broader market implications of other regulatory initiatives;
- targeted to identified systemic risks;
- consistent with the FSB's intention to only take measures that are proportionate;
- mitigating regulatory fragmentation by encouraging consistent standards across the FSB's membership; and
- are sensitive to other regulatory developments.

15) What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?

Although AFME covers only wholesale capital markets, and not retail products such as savings accounts, members have offered some general comments on targeted savings accounts to support the financing of long-term investment projects, which presumably provide a guaranteed fixed return and in some cases with certain tax concessions. Members expressed some questions as to whether, if the funds were set up a pan-European level this would add incremental funding, or rather cannibalise existing deposits from standard bank accounts. Members note that in many countries there are a variety of models that could be explored. Pensions products are a good idea, but these could be difficult to roll out EU wide as they all have a relationship to a national taxation system, and may or may not get national rebates on individual contributions.

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

We recognise that if it is desired to obtain greater equivalence in the tax treatment of debt and equity finance, this could in theory be achieved through the introduction of some sort of deemed or notional interest deduction in respect of equity capital. If such a change were intended to be revenue neutral, it would probably need to be accompanied by an increase in the rate of corporation tax to compensate for the additional deduction that would become available.

Achieving equivalence between debt and equity by denying a deduction for interest expense could give rise to a significant distortion. As noted above, currently the tax treatment of interest income and expense is generally aligned⁴. If that alignment were not preserved there would need to be a very significant reduction in the corporation tax rate, otherwise there would be a serious frictional cost which would significantly impair lending to businesses and individuals. We note that the impact would be less if the denial of an interest deduction were only to apply in relation to debt which is classified as regulatory capital, but nonetheless there would still be the potential for a significant distortion for the reasons outlined.

For entrepreneurs, capital gains tax relief for small business owners on the sale of their businesses could incentivise the owners to issue more equity.

17) What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long term saving in a balanced way?

⁴ It should be noted however that in many jurisdictions there are restrictions to the deductibility of interest expenses under thin capitalisation rules.

Our comments on taxation issues are covered under question 16.

18) Which types of corporate tax incentives are beneficial? What measures could be used to deal with risks of arbitrage when exemptions/incentives are granted for specific activities?

Our comments on taxation issues are covered under question 16.

19) What deeper tax coordination in the EU support the financing of long-term investment?

Our comments on taxation issues are covered under question 16.

20) To what extent do you consider the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

The Consultation cites research that highlights equity valuations can be more volatile than bonds. This is to be expected with respect to the volatility which relates to the risk of non-payment, since equity is more junior to debt in the repayment hierarchy in the event of liquidation, and therefore carries greater risk of non-payment. Also equity holders' returns are generally paid at the discretion of the company whereas debt is contractual in nature. The higher risk that equity holders therefore face compared to bond holders is compensated for by a higher return. However, debt instruments can demonstrate volatile valuations too where they carry a fixed (including zero) rate of interest, especially if they are long dated.

If investors choose to reduce their equities exposure due to equities' greater risk of non-payment compared to debt, this is primarily an investment decision based on how well the characteristics of the different instruments match investors' objectives rather than a response to the accounting required for such investments.

IAS 39 is the accounting standard which currently applies to listed European companies long term debt and equity holdings. Generally, the standard requires equity investments to be carried on balance sheet at fair value. However, in certain circumstances, equity investments may be held at cost less impairment.

IFRS 9 Financial instruments, which is intended to replace IAS 39, is expected to be effective in Europe in either 2016 or 2017 once endorsed by the European Union. We agree with the fundamental measurement principles of IFRS 9, that an entity's reported performance should reflect its business model. Fair value is very often the appropriate measure for financial assets and provides investors with the most transparent and decision-useful information. IFRS 9 requires fair value measurement for equity investments, including fair value through other comprehensive income. Subject to certain criteria, equity investment is also permitted to be held at cost – a non-volatile measure – provided the investment is not managed for fair value. Relatively minor deviations from this fact pattern will result in the entire investment being held at fair value with gains and losses being included in profit or loss. Such deviations could include various terms which enable financial institutions to share in the returns from a project, or reduce its risk.

It is worth noting that for many equities the calculation of fair value, whilst based on generally accepted valuation techniques, can be a judgmental exercise. This particularly applies to private equity investments and other unquoted equity investments for which there is no comparable market information available. This gives rise to practical difficulties in arriving at a reliable fair value. However the accounting standards prescribe a mandatory hierarchy of valuation inputs used to calculate fair value which prioritises observable information. In addition disclosure requirements identify which investments are most subjective (where valuation would be based

on non market observable data) and the sensitivity of the valuations to changing one or more inputs.

We consider that the accounting currently required under IAS 39 and in the future by IFRS 9 provides appropriate and decision useful information in the financial statements. Management can supplement the performance statements with suitable disclosures regarding their business model, investment strategy, the nature of the investments; the long term expected performance of investments and corresponding incentives to make long term investment decisions. If there is short-termism, we do not believe it has or will be caused by the accounting treatments required or permitted by IFRS.

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

In our view, it is advantageous for a company to attract both long-term and short-term investors for an investment that is itself long-term e.g. equities. In such cases, there can be a symbiotic interplay between the two types of investors, with the long-term investor holding the investment over time while the short-term investor provides liquidity and price confirmation during the interim periods allowing longer term holders a liquid market in the event that disinvestment is required or as an indication of value to assure those who are holding over a long period.

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

In our view, there are many performance measures to promote long-term investment strategies, but these measures should not discourage asset managers from offering short-term strategies to investors who may wish to pursue such a strategy. It is, of course, necessary for risk parameters of any investment strategy to be matched with the risk tolerance and investment objectives of the investor. In our view, it would be ill-advised to limit the investment objectives of any investor in the absence of market abuse concerns. We have seen the argument that short selling should be considered to be prone to market manipulation, but IOSCO, the EU Commission, and ESMA, and most Member State's competent authorities have accepted that short selling is a necessary, legitimate and healthy activity.

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

There is no apparent need to revisit the notions of fiduciary duty in the context of long-term financing. The Commission Staff working document suggests that large investors and authorities could address perceived conflicting objectives as between asset managers and principals, by requiring agents to adopt a long-term investment approach based on long-term dividend flows, rather than short-term price movements. We agree that investors may choose to do this. We do not agree that this investment model should be imposed by authorities. We note that many companies, from biotech and technology sectors but even financial bellweather investment companies such as Berkshire Hathaway are not based on dividends since many companies do not pay dividends.

It would not be wise or appropriate for regulation to require asset managers to take a long term approach – whether favouring dividends and eschewing short term price movements. It is the right of the investor to choose his/her investment strategy whether it be long term or short term, value based or technical trading, as well as to choose his/her investment objectives.

According to the Commission Staff Working Document:

“Other factors: the general evolution of economic conditions seems to be biased against “patient” activities. The development of information and communication technologies has facilitated the development of short-term and speculative transactions. In addition, a number of other factors may create a short-term bias. These factors include:

- A lack of engagement by long-term investors, which can reduce the focus of companies on longer-term strategies;
- Shareholder value which currently prioritises the maximisation of share value against the longer-term fundamental value of the firm; and
- The nature of the relationship between investors and asset managers and the way asset managers’ incentives are structured, which is argued by some to contribute to increasing short-termism and mispricing.

Corporate governance policies may target this suboptimal market behaviour.”

We do not agree with this analysis of “suboptimal market behaviour”. Whilst we support a number of measures to encourage the channelling of resources towards “patient capital”, we do not believe that the objectives of the Green Paper are served by regulation seeking to direct the choices, interests and values of market participants.

24) To what extent can increased integration of financial and non financial information help provide a clearer overview of a company’s long-term performance, and contribute to better investment decision-making?

Throughout the series of discussions on integration of financial and non-financial information the members considered the Commission’s Staff Working Document, and specifically referred to the “market failures” section in the paper:

“Market failures include mainly externalities (where the marginal benefit to the investor does not include the marginal social benefit given that not all costs/benefits fall to the investor); market power (which could result in the overpricing of LTI finance); and asymmetries of information which leads to indirect finance, but the issue of information problems is still present.

Example: Asset management – principal agent problem: Long-term investors ('principals') often invest via 'agents' such as fund managers. Agents usually have better information and different objectives than their principals. It has been argued that the net result may be that agents, in pursuing their own interest, misprice securities (by mimicking their counterparts in other firms to exacerbate bubbles and crashes) and extract rents. In principle, large investors and the authorities could address these problems by changing the way investors deal with agents – e.g. by requiring agents to adopt a long-term investment approach based on long-term dividend flows rather than on short-term price movements.”

The “market failures” mentioned here are not clearly set out or accompanied by rigorous analysis and may be more in the eye of the beholder than the result of objective analysis. It appears that the failure is seen as the investor not taking account of the social benefits resulting from the investee’s activities in its investment analysis. This is perhaps another way of saying that in order to contribute to better investment decision-making, it is important that investors have a range of financial and non-financial information in an integrated and accessible form. In this context, proportionate and focused non-financial reporting on the company’s adherence to non-financial requirements established in separate legislation could be somewhat helpful to some investors, but it is important that the timing, method, and subject matter of reporting be clearly defined and subjected to cost benefit analysis. The members considered that the reporting information may be contained in the annual accounts, or in documents such as offering circulars prepared for the purposes of a specific transaction.

Companies generally see their main obligation is to deliver profits to their shareholders while complying with law and acting with integrity and prudence. However, on the other hand, the companies are aware that they are not in the best position to determine social or environmental policy, for that is the role of an elected government acting in a focused and transparent process, and believe that generally the information in the accounts and in documents such as offering circulars is presented in a suitable form.

We also note the improvement in information reporting, transparency and standardisation in specific product areas, such as securitisation. Industry initiatives such as the Prime Collateralised Securities (PCS) quality label programme require extensive disclosure and compliance with central bank standardised reporting standards, which were developed with active input from the industry.

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

We consider that it is important for firms to communicate effectively with investors and to help them understand primary financial statements and related notes. It is not clear to us at this stage that additional long-term benchmarks are required; however we would be interested to consider the idea further.

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

Please see response to question 28 below.

27) How could securitisation instruments for SMEs be designed? What are the best ways to use securitisation in order to mobilise financial intermediaries' capital for additional lending/investment to SMEs?

Over €100 billion of SME securitisations have been issued in Europe. Many of these transactions have been placed with external investors, while others have been used for repo transactions with central banks. Specific obstacles and solutions regarding further SME securitisation are described in the AFME Oliver Wyman paper, which primarily focus on capital as well as funding costs.

28) Would there be merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitised products specifically designed for SMEs' financing needs?

Given the reliance of SMEs on bank lending, there needs to be careful consideration of potential solutions. SME lending is typically for small balances and either short-term or revolving. Banks have credit review teams capable of analysing large amounts of small transactions. SME loan origination often also requires face-to-face interaction, as financial accounts are either less detailed or do not provide a full picture of the business. Direct capital markets origination of SME loans is feasible in some countries, but not in others where loan origination requires a banking license. Even where origination by non-banks is possible, many interviewees stated that it did not fit with their business model, due to the need for local origination capabilities, increased number of credit analysts, etc. As a result, SME lending is expected to continue to be provided mainly by banks rather than through direct capital markets origination. We see a number of key areas for improvement:

Consider establishment of further national government-backed SME support agencies. These could include similar structures to the German KfW model or SME business banks and provide either direct or indirect funding to SMEs.

- Consider expansion of public sector support for SMEs. Evaluate whether the current level of public sector support for SME is sufficient, given the size of the EU economy, recognising public sector funding constraints. Further support could be provided by the EU Commission, EIB, EIF, national governments or further use of EU structural cohesion funds. Types of support could include further provision of guarantees and/or funding for SME loans, either directly or through securitisation structures. For example, guarantees on mezzanine tranches of securitisation tranches retained by issuing banks, if provided by a 0% risk weighted counterparty such as a national government agency or the EIF, would free up significant capital for new lending. Public sector support could also include ensuring properly calibrated capital charges for investors in SME securitisations under Solvency II and/or the potential inclusion of high quality securitisations in bank liquidity buffers. These could be similar to the type of existing public support provided for covered bond funding in Europe which is also used by banks as a form of secured lending, mainly for residential mortgages. The industry welcomes the recent consultation by the ECB to the EIB on how to increase SME securitisation volumes.
- Consolidate and/or simplify communication of existing SME lending schemes to maximise efficiency, usage, and impact. At present there are a range of schemes working within and across regions, which could potentially be used to greater overall impact if resources were pooled. Where multiple schemes remain for different purposes, a comprehensive register should be established and communication and documentation enhanced to make it easier for SMEs and/or banks to find the appropriate scheme(s). Banks should also be encouraged/mandated to highlight such schemes to failed loan applicants.
- Establish credit mediation services where they do not already exist, to support SMEs in making credit applications and stepping in to resolve pricing/credit disputes between businesses and lenders. Communication could also be enhanced to increase usage of existing mediation services.
- Create centralised pan-European and/or national SME information and rating databases using a pre-defined, pan-European standard template. Such common SME data from a centralised single website would improve communications and allow firms to quickly analyse comparative risks and market sector trends across borders. Rating calculations could be performed on this standardised SME data, using a fully transparent and simple methodology. This would allow quick cross-border comparisons and provide a benchmark for the risk of SME aggregated debt.
- Enact capital gains tax relief for entrepreneurs when selling small business equity stakes to promote entrepreneurialism and reinvestment in other small firms.
- Consider tax deductions for small business equity, akin to the current deductions for loan interest payments. This would reduce the financial disincentive for small firms to increase equity, which in many cases is more appropriate than increased debt funding.
- Consider stamp duty exemption for shares in small businesses to increase the value of raising capital.
- Finalisation and clarification of MiFID proposals. Recital 90 in MiFID 2 includes the following constructive wording: “The requirements applying to this new category of markets need to provide sufficient flexibility to be able to take into account the current range of successful market models that exist across Europe. They also need to strike the correct balance between maintaining high levels of investor protection, which are

essential to fostering investor confidence in issuers on these markets, while reducing unnecessary administrative burdens for issuers on those markets. It is proposed that more details about SME market requirements such as those relating to criteria for admission to trading on such a market would be further prescribed in delegated acts or technical standards.” The resolution of how to strike this correct balance will need to be clarified by policymakers before implementation.

29) Would an EU regulatory framework help or hinder the development of this alternative non-bank sources of finance for SMEs? What reforms could help support their continued growth?

Yes, this should be considered. Please see rationale above.

30) In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of European economy?

Broadly, as indicated in the AFME Oliver Wyman report, corporates and investors are by far most concerned about the overall economic environment on growth, as well as the overall impact of regulation. In terms of specific barriers to funding, a summary of solutions to the almost 50 barriers identified is contained on page 18. The relative impact of each solution is identified as well as the relative ease of implementation. Following is a summary of the key findings of the report:

- *Improving access to finance for SMEs:* Interviewees believe that lending to small businesses (SMEs) is likely to remain primarily in the hands of banks due to the small size of transactions and the local nature of commercial relationships, although they say that non-bank sources such as fund managers could add some capacity over time. Securitisation could play a larger role, if the economics of SME loan securitisation can be restored.
- *Hedging for large corporates and more private placement and HY issuance flexibility:* Large corporates say they do not generally experience problems with accessing funding but they would like to see action on the unforeseen and unintended consequences of regulation which is *reducing availability of the products they need to be able to hedge business risk*, as well as increasing their cost of capital.
- *More flexibility in accessing funding for large and mid-size corporates:* Both large and mid-sized corporates would like greater flexibility in accessing funding as they need to be able to tap large pools of cash quickly, depending on market conditions. They say that certain capital market sources of finance, such as the European private placement and high yield bond markets should be expanded, which could be achieved through expanded legislation as well as more harmonised EU.
- *Infrastructure funding:* Infrastructure is crucial to long term growth and productivity. However, funding long term infrastructure investment has become much more expensive for banks, as a result of the Basel III reforms and changes to bank funding costs. In response, this market must be made more accessible to non-bank investors. A range of reforms should be considered, including rules to reduce political risks associated with infrastructure regulations or tariff structures, increased transparency of planning and procurement processes and greater acceptance of capital markets instruments as part of an overall financing package. While institutional investors can bring new funding capacity, public

sector commitment will remain crucial in areas such as project budget capacity and certainty of tariffs.

- *Lending to businesses in crisis-affected countries:* Funding issues in these countries are particularly acute and may require consideration of special types of solutions, including the possible relaxation of certain European Investment Bank (EIB) eligibility rating criteria for partner banks, and refinement of sovereign CDS regulations and swap contract triggers to improve investor ability to hedge the sovereign risk component of corporate financing transactions.