Deutsches Aktieninstitut

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

Comment of Deutsches Aktieninstitut e.V., 28 June 2013

1 Introduction

Deutsches Aktieninstitut welcomes the aim of the Green Paper to foster long-term financing. Long-term financing is a precondition for a prospering real economy and consequently for economic growth. In order to achieve these objectives a regulatory framework is required which at the same time

- provides for the development of new finance instruments with a long-term perspective,
- allows companies a flexible access to means of long-term finance and
- correspondingly sets the right incentives for long-term investments.

Efficient rules are necessary. Therefore, it is essential to dismantle regulatory barriers which encumber investors – banks, insurers, institutional and retail investors – to finance long-term assets.
In particular it is important that

- access to capital markets for SMEs is improved;
- retail and employee share-ownership is supported;
- banking regulation is adjusted carefully;
- the liquidity of markets is not harmed.

Please find below our detailed answers on selected questions.

2 Responses to specific questions

1) Do you agree with the analysis out above regarding the supply and characteristics of long-term financing?
2) Do you have a view on the most appropriate definition of long-term financing?

We agree with the objective of the Green Paper to strengthen long-term financing in Europe. Nevertheless, the proper functioning of capital markets as intermediary between households and the corporate sector highly depends on short term investments as well. The latter provide the necessary liquidity as a prerequisite for long term investors to invest in shares, bonds etc. in a (transaction) cost efficient manner. Therefore, one should be very careful to not discriminate short term investors as "inefficient" or "speculative".

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?

Against the background of a tremendous change in the regulatory landscape and the still ongoing process of deleveraging in the financial sector we expect that credit policy of banks will become more restrictive. Nevertheless, especially in economies which are more focused on bank financing – e.g. Germany – banks will continue to play an important role in long term financing in particular for small and mid-sized companies.

Too restrictive rules in banking regulation should not undermine the capability of banks to meet the long-term financing needs of the real economy. Especially the Net Stable Funding Ratio (NSFR), part of the Capital Requirements Directive / Regulation and expected to enter into force in 2018, is very likely to constrain long term bank financing significantly. The NSFR will decrease maturity transformation in the banking system. As a result banks have to fund long term loans granted to the real economy to a much larger degree with long term liabilities. Therefore, costs for long term bank financing will increase which will negatively impact companies financing of long term projects. To avoid this unintended effect it is important to evaluate the impact of the NSFR on long term financing carefully. The final calibration of the NSFR should properly reflect the results of this impact assessment.

Furthermore, in the context of the above mentioned changing regulatory environment we observe the development that the legislator tends to launch additional and revisionary regulatory initiatives before previous initiatives have been implemented, granted time to work and have been thoroughly evaluated with regard to their effectiveness. Additionally, reliable data to comprehensively assess the (potential) success, the interaction and – that's our main concern – non-intended consequences of legislative measures is often missing.

In this context the reform of the structure of the banking system as proposed by the High-level Expert Group and the European Commission could likewise result in unintended consequences for the real economy as well. It remains doubtful whether an EU-wide solution for structural changes in the banking sector is an appropriate way to further enhance systemic stability. Financial systems have grown and developed over centuries especially regarding the legal and institutional structure of the respective country. Therefore, different institutional settings provide different ways for an effective transformation of savings into investments. Interferences with banking structures may have different impacts in different countries when not appropriately fitted in the existing institutional context. For example, regulatory measures setting incentives for a separation of investment banks and commercial banks would affect Germany to a higher degree than countries where universal banks are minor phenomena. It is very likely that the institutional change would have negative consequences for long term financing of the real economy.

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

It is worth to note that not only institutional but also retail investors should play a greater role in long-term financing. E.g. retail investors which invest in shares for old age provisions are very important long-term investors. Nevertheless, shareholder-ship is not very widespread among retail investors. One reason is that many retail investors are not sufficiently familiar with share-ownership and hence reluctant to invest in shares. It is therefore crucial to enhance financial literacy in the population in order to put retail investors in the position to properly assess the opportunities (and the risks as well) of share investments. Efforts on European level should be extended to encourage financial literacy among retail investors.

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 pension funds, such as IORPs?

Insurance companies could play an important role in financing renewable energy projects which are an excellent example for long term investments. So far Solvency II requires insurers in the standard approach to back these projects with 49 % capital. This means that the capital requirements for renewable energy projects under Solvency II equals the amount of capital which has to be put aside for private equity or hedge fund investments. To incentivise insurers to invest in renewable energies and to contribute to the political aim to change the energy mix towards these sustainable energy sources it is absolutely necessary to decrease risk weights under Solvency II for these investments.

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

There are different impacts of regulatory reforms on long-term financing. According to the revised Rating Regulation (CRA III) recently entered into force issuers of structured finance products are required to mandate at least two rating agencies for the rating of structured finance products. Furthermore, issuers have to provide additional information on structured finance products; now it is up to ESMA to develop regulatory technical standards specifying the content, frequency and process of this transparency obligation. To not overburden the issue of structured finance products which would run counter the aim of this Green Paper it is necessary that ESMA appropriately takes into account issuers resources and investors needs.

In addition, in order to not encumber companies to raise capital the financial transaction tax as proposed by the European Commission foresees an exemption for primary market transactions. Unfortunately, the definition “primary market transactions” is very limited and does not include the issue of structured finance products. This would decrease the attractiveness of structured product financing and would furthermore contradict Art. 5 of Directive 2008/7/EC which prohibits the indirect taxation of capital contributions. It is worth to mention that this is only one of many other negative side effects of the financial transaction tax (see also our answer to question 26).

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

The double taxation of equity – on corporate and on investor level – discriminates equity financing vis-à-vis debt financing. E.g. in Germany this results in a total tax burden on earnings of equity investments of ca. 50 per cent compared to a tax burden on debt which amounts up to ca. 30 per cent.

To avoid distortions of capital accumulation to the detriment of equity it is necessary to implement a tax regime with similar rates for equity and debt. This could be achieved by a tax relief on the level of investors or on company level.

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?

See our answer on question 16.

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

Employee share ownership plays an important part in increasing the proportion of shareholders with a long-term engagement. Consequently, the European Commission's objective to create a favourable environment for the development of employee share ownership - as promoted in its action plan on company law and corporate governance – should be supported.

Furthermore, it is worth to evaluate the benefits of instruments which provide companies with the flexibility to incentivise long-term investment of shareholders. Such instruments could e.g. be higher dividends or multiple voting rights for long-term investors according to the companies' articles.

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?

We are not sure if we understand the meaning of this question correctly. A further integration of financial information is hardly imaginable. Listed companies not only report extensively in their annual reports about their financial data but also in their quarterly reports, they present important financial data on road-shows and publish it on their websites. In our view the regular information and financial data published by companies sufficiently enable investors to make sound investment-decisions.

Sustainability is an important factor to rebuild trust and to foster long-term investments and thus economic growth which are in the core-interest of listed companies. Being aware of this more and more companies report on their sustainability efforts. But whether, how and in what extent companies report on their sustainability strategies and efforts must be left to the companies themselves. As in Corporate Governance matters companies must be given the chance to develop best practices on Sustainability/Corporate Social Responsibility in dialogue with the relevant stakeholders. This is an on-going process and has been over the last decade. If sustainability aspects have a possible impact on the performance of the company already today companies are obliged to report about them.

As the Commission itself states in its Memo on Disclosure of non financial and diversity information it is difficult to present evidence that the potential advantages of non-financial reporting outweigh the costs for the companies linked thereto. Keeping this in mind we don't think it is appropriate to push for more (integrated) non-financial data of companies.

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

The objective to promote capital market-finance for SMEs is countered by extending the scope of application of MAR (Art. 2 Nr. 1, Art. 12, Art. 13, Art. 14 MAR), MiFIR/MiFID II (Art. 1 MiFIR) to Multilateral Trading Facilities (MTFs). Stock Exchanges all over Europe have created privately regulated SME markets which typically will qualify as an MTF.

Extending the scope of regulatory requirements designed for regulated markets and large public interest entities also to SMEs and their market segments will create additional administrative burdens for these companies and act as a severe disincentive for IPOs of smaller issuers. In addition the tendency to tighten requirements for all listed companies (with the latest example of making country-by-country reporting mandatory for a large number of listed companies) also works in this direction.

Although the need for sustainable business practices is widely acknowledged as key factor to foster long-term investments the legislator should be very cautious to not create an additional burden of bureaucracy and costs for companies by a potential inflation of non-financial reporting obligations. Therefore, we doubt that the proposal of the European Commission on non-financial- and diversity reporting launched earlier this strikes the right balance between the need for sustainable behaviour and the additional costs which have to be borne by companies. Especially the notion of integrating the sustainability report into the annual report and thereby making it subject to an audit will raise the costs for producing the report significantly and will decrease the attractiveness of an IPO as a source for corporate finance. The proposal should adequately take into account the specifics of companies seeking long-term finance on capital markets.

Finally, these shortcomings will be aggravated by the possible introduction of a financial transaction tax (FTT) as it will lead to a severe decline of market liquidity which will make capital market finance significantly less attractive for SMEs. As liquidity is a prerequisite for investors to buy shares or bonds especially small and medium-sized issuers have to rely on market makers if they intend to successfully access the capital market as a source of funding. In order to support trading of less liquid securities market makers permanently place bid and ask orders to ensure market liquidity. Both the purchase and sale of securities by the market makers are “standalone” transactions that are subject to the financial transaction tax proposed by the European Commission. As profit margins of market makers are relatively small the FTT will largely or completely erode their earnings. The business of "market making" is therefore in danger of disappearing with the result of decreasing liquidity and increased costs of finance.

Especially for small and medium-sized issuers financing through the capital market would be hardly possible under these circumstances. The financial transaction tax, thus, contradicts the aim of the European Commission expressed in this Green Paper.

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/investments to SMEs?

Please refer to our answer to question 10.

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