The Association of Corporate Treasurers
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Comments in response to

Green paper: Long term financing of the European economy
From European Commission,

March 2013

25 June 2013

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter.

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Long term financing of the European economy is a wide ranging subject with multiple interdependencies making the issues very complex. As the green paper acknowledges, it is crucial for returning to the long-run trend of economic growth. We therefore

welcome this attempt by the Commission to undertake this high level and multi facetted review.

Immediately following the financial crisis the legislative imperative has been to restore financial stability but in so doing the focus mistakenly gave little consideration of the impact on the real economy. We perceive that more and more legislators and regulatory authorities are now realising that that analysis of the wider implications of any regulatory change is crucial. We see this paper as evidence of that much needed re-focussing on the real economy. Furthermore, given the widespread changes currently being made to the financial systems and markets a further review of longer term finance is needed once the changes have taken effect.

Your paper is absolutely correct in saying:

> *"As part of a broader policy response, it is appropriate to ensure that the detailed calibration of the new regulatory and supervisory framework most effectively enables the financial sector to support the real economy, without jeopardising financial stability."*

Elsewhere it says *"Financial stability is essential but it is not sufficient"*. We agree. All too often there is excessive focus on financial stability as the paramount objective even if thereby the financial system becomes useless and unable to meet the needs of the real economy. There will always be a balancing act between a sound financial system and regulating the system to death. We believe that the balance has swung too far toward the safety of the financial system such that the economic prospects for the real economy are being hampered. There is a need for some recalibration of regulatory requirements or at least a greater willingness to implement regulation in phased stages and each further stage being dependent on a damage assessment to date.

The ACT has been concerned about private placement bond markets for mid and mid+ companies. At the request of the UK Government we chaired a working group on this and which issued its report in late 2012.[1]

We have witnessed many regulatory initiatives for financial services markets that taken in isolation are being introduced for very good reasons, but which have extended in scope to include non-financial companies or which through indirect effects have detrimental consequences for non financial companies. Inadvertant damage to the real economy should be avoided.

We welcome appropriate exemptions for non financials such as in EMIR and CRD IV but some disincentives still remain. More recent proposals such as the Financial Transaction Tax are misguided and rather than taxing financial firms will tax the real economy, damage liquidity and push up the cost of finance and risk management products.

Response to specific questions

We have structured this response to your Green Paper as best we could around your questions to assist in your analysis of feedback. Inevitably there are some cross cutting themes and these have, to a large extent, been summaried in the general paragraphs

[1] The report on UK Private placements is available at http://www.treasurers.org/node/8624

above. On certain questions we refrain from comment since others are in a better position to provide a response.

1) Do you agree with the analysis set 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?

Access to a diversity of finance and with a variety of maturities available will help an economy to thrive. What is long term will depend on your point of view. A small company whose sole source of finance is in the form of an overdraft that can be withdrawn at the bank's choosing will be reluctant to invest or expand for the future. An amortising term loan of just three years could be enough to prompt confidence and growth. That said we interpret this green paper to be more concerned over finance and investment over longer periods, anything from 5 years to 25 years or even longer. In a period when risk is high on the agenda lenders will understandably have a preference for shorter term exposures so a review of longer term finance is helpful, but we should still have regard to that shorter term finance as part of the review.

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?

Banks are probably one of the most convenient and most easily accessible means of channelling savings through into investment and performing the traditional roles of maturity transformation and delegated monitors of credit. This should surely continue. If new similar, or not so similar, market participants develop, that is all to the good in providing diversity and competition. Shadow banking, if that is what people decide to call it, is a force for good to be encouraged, subject to suitable investor protections and controls over financial stability effects. However it is not necessary to regulate shadow banking along identical lines to bank regulation. Investors and borrowers are capable of making their own assessments as to benefits and risk.

We accept that as the banks come out from the years of financial crisis and with tighter prudential rules now applicable, their balance sheets are constrained but their network and expertise can be put to good use. In addition to using their own balance sheets, banks can act as intermediaries between investors and borrowers, be that as arrangers in the conventional bond markets or through securitisations of their own loans, or through newer channels such as crowd funding.

Credit analysis and information is important in encouraging the flow of new finance from savers and investors. This can be provided by analysts and the credit rating agencies, but banks could use their expertise in this area too, with added credibility through their own retained credit exposure. It is possible to envisage a model whereby banks identify borrowers and after suitable credit appraisal only part fund them, with the balance provided independently from crowd funding sources via which both retail and professional investors participate. The "skin in the game" from the banks could give a powerful message to other funders. With securitisations, however, it must be recognised that initially banks may have the risk of over-lending to non-financial companies (especially to commercial real estate companies) and suffering the consequences.

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

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

We agree with your comment:

> *National and multilateral development banks can be useful in stimulating private financing given their specific public policy objectives related to broader economic, social and environmental (as opposed to purely financial) value added.*

There is a role for such banks or agencies in filling certain market gaps or where there are some other public policy objectives to be achieved. However in general the ACT believes in free market solutions and if there are gaps in the provision of funding one has to ask whether there is some other barrier affecting the funders that need to be addressed. The borrower itself may be part of the problem if the business is undercapitalised, poorly managed or not assessing its own project risk properly or not prepared to pay up for its real riskiness. On occasions when the market forces are slow to recognise an opportunity the national and multinational development banks can help but there are dangers that their involvement could distort the market signals.

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

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?

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

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

In the light of banking conditions there has been a significant adjustment to the funding policies of many large companies. The proportion of debt being raised from institutional investors has increased while the bank funding proportion has declined. The reliance on undrawn bank facilities to provide "standby" funding has somewhat declined and to an extent holdings of short term cash have increased and are being used for the same function – providing instant liquidity when needed.

So institutional investors are already playing a greater role in funding and we expect this to increase further. For insurance companies Solvency II regulations ascribe benefits to matching of investments with liabilities but we understand that some insurance liabilities are regarded as shorter term such that appetite for very long term investing is likely to be diminished. In the UK there has been a healthy market for 25 year funding but this is now threatened, a particular concern for utilities. Furthermore the risk treatment from investing in unrated paper acts as a material discouragement to investors which is very damaging to the prospect for the development of private placement markets for unrated mid-sized borrowers. Such companies may find it uneconomic to go through the rigours of the full credit rating process. Some form of lower cost "ratings-lite" may yet be developed to address this point.

As a follow up from the UK government inspired Breedon report into funding for business the ACT was asked to investigate the barriers to the development of a UK private placement market[1]. The ACT report found that there were a myriad of relatively small barriers which could in time be overcome, but the problem of Solvency II treatment of unrated private placement paper for insurers was far more intractable and was acting as a brake on many firms attempting to deal with those other smaller hurdles.

The increasing use of the US private placement market by UK and European companies is indicative of the need for a better PP market in Europe to serve those issuers who are unlikely to issue in sufficient size to satisfy the international bond markets where some degree of liquidity (albeit modest) is sought. The German Schuldschein market is held up as an example of a private placement market that is working well and we are pleased to note that non- German issuers are beginning to tap that source. Other countries are concerned about interaction of insurance legislation with private placement markets like Schuldschein.

Reaching a critical size of issue is necessary to make it economic for both the issuers and the investors. Pooled investment vehicles can address this and we would hope that structures will evolve. The ACT's working group report found that provision of basic information and some form of credit analysis was another essential need, if only because it was uneconomic for this to be replicated by every investors acting separately. Information and dealing platforms or exchanges could help serve this need and indeed the internet has the power to simplify the flow of information and to make connections between willing borrowers and lenders. We expect this to develop.

At this point it is worth repeating the point that there is a danger that piecemeal financial regulation be that MiFID, CRD IV, Solvency II, can have unintended consequences. It is crucial that each new regulation be considered in terms of its effect on the wider economy.

The regulation of Credit Rating Agencies is a case in point here. There is an apparent determination from the Commission and politicians to reduce the power and influence of the CRAs, but from the borrowers perspective they serve a valuable purpose in providing a trusted channel of communication to investors, which is seemingly ignored by the authorities.

The Financial Transaction Tax currently being discussed is a further example where a side effect will be an added cost to corporates who issue securities (even if primary issuance is exempt the cost derived from the secondary market will affect new issue pricing). Increasing the cost of capital has a direct negative effect on investment which we assume was not the purpose of the FTT.

Before any regulatory change is approved it is crucial that a good analysis of the wider implications is undertaken, including an assessment of the impact on the ability of companies to finance themselves.

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?

It is essential that he cumulative effects of international prudential reform be considered and monitored. We accept that it is not easy to model all the interrelated consequences, especially second and third order effects and later, but the directional signals should be apparent. As mentioned in the response immediately above, we know that Solvency II will have a negative impact on investor appetite for unrated securities, but would find that impossible to quantify precisely. This directional impact should be taken into account in planning regulations. Then, post implementation, there should be a rigorous assessment of the actual impact and a willingness to back-track if the effects are too negative.

In a similar fashion there have been concerned that plans for a Solvency II style of regulation for pension funds could hasten the closure of such schemes and reduce the pool of willing long term investors. We therefore welcome the recently announced delays to the concept of capital buffers for company pension schemes.

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

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

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

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?

As mentioned earlier the ACT produced a report on the barriers to the development of a £ private placement market[1]. While there were some apparent obstacles of a regulatory nature it is interesting to note that many of the problems could be classed as in some way behavioural. Examples being a lack of awareness; an objective of liquidity even though conventional bond markets are often liquid in theory rather than practice; a reluctance to consider new ideas or to resource up investor departments ahead of volumes and the fact that the market was too private so even though transactions are happening, few get to hear about them. Since so many of the barriers were not really that substantial it was thought that government pressure and a general visibility and knowledge about the needs of investors and borrower could, over time, engender a change in attitudes. The Green Paper from the Commission can of itself contribute to that wider debate and awareness of needs.

Your paper raises the question as to whether the economy and businesses need more equity rather than debt. This is a very valid question. For early stage companies, small companies, or particularly risky activities or new project finance, equity funding could play a larger role. If companies maintain that they are failing to find debt funding at an acceptable price it does imply that a self-review of their debt and equity funding mix could be in order.

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?

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

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

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

Since interest costs on debt obligations are a mandatory cost and cash-flow claim for a company, we believe it would self-evidently be depressing to economic activity if tax deductibility if interest cost were not available. Elimination of any double taxation of dividend payments (namely tax of company profits and again in the hands of the dividend recipient) would be a useful way to reduce debt incentives. Lowering corporate tax rates generally would also reduce debt incentives.

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

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

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

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

(Q20 to 23 no comment)

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?

The provision of good information and disclosure is always helpful in gaining the confidence of investors. Narrative reporting and a well targeted risk commentary will help investor understanding. The existence of a credit rating will also help to communicate the board's strategy and plans to the market in digested form that avoids disclosure of confidential information.

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

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

SMEs may not have particular expertise in financing and typically will not have the time and resources available to seek out and evaluate anything too complex or specialised. Relative simplicity in any SME finance incentives or government schemes and good channels for communication and publicity will be needed. At a very specific level tax fairness on deductibility of venture capital / angel losses on start-ups is a first step.

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?

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?

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

It should be noted that individual SME needs can be for very small amounts so high costs cannot be justified for anything complex. Securitisation of portfolios of small loans therefore is an attractive mechanism. Securitisations via un-geared vehicles, with proper transparency, are to be encouraged.

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 the European economy?

No comment

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