BUSINESSEUROPE

THE DIRECTOR GENERAL

Mr Michel Barnier
Commissioner Internal Market and Services
European Commission
200 Rue de la Loi
1049 Bruxelles

25 June 2013

Dear Commissioner,

RE: GREEN PAPER ON LONG-TERM FINANCING OF THE EU ECONOMY

Businesses' ability to access finance currently varies considerably across Europe. In some countries, for example, Spain, Italy, Portugal and Greece, the supply of finance, particularly to SMEs is already a key barrier to growth. In other countries, limited demand for finance from businesses who remained concerned by the weak and uncertain business environment is playing a greater role in contributing to the low investment rates we see in Europe today.

But as the recovery gradually starts to take hold we will need to have ensured that we have begun to address the issues of access to finance as companies start to want to take forward their investment projects.

We therefore believe the Commission's Green Paper on long-term financing of the European economy is extremely timely. As your staff working paper notes, total EU investment up to 2020 should normally be in the region of €24 trillion.

Our attached paper responds in detail the issues set out in the Commission's Green Paper. Overall, we believe there are five key areas under which EU policy makers need to take action to improve long-term financing.

1. **Implement the banking union**

Lending costs continue to vary substantially across the euro area. While a small business looking for a one year loan will typically pay a little over 2% in Germany, Belgium or Austria, this compares to around 5% in Spain or over 6% in Portugal – if indeed the loan request is accepted – and much higher in Greece.

In order to break the negative feedback loop between sovereign and bank financial positions, the EU must urgently finalise and implement the new single supervisory mechanism and progress towards a deeper European banking union. This includes strengthened resolution and deposit insurance schemes.

2. Ensure that prudential rules strike the right balance between increasing financial stability and supporting companies' need for capital for investment

BUSINESSEUROPE supports regulatory initiatives that address the regulatory failures that led to the financial crisis and reduce the risk of new crises occurring. Companies are the first victims of problems in the financial sector as we have seen.

But reforms must strike the right balance and be mindful of their consequences for non-financial companies which depend on the services of financial companies for their investments in the real economy. This will be particularly important when taking forward Solvency II and liquidity requirements.

Moreover, the Commission must urgently deliver on its promise to deliver a comprehensive impact assessment which addresses the cumulative impact of different reform measures.

3. Develop complementary sources of finance to bank lending

For historic reasons, banks' share of credit intermediation is 3 times higher in the EU than in the US. Given regulatory and balance sheet pressures which will inevitably put bank lending under pressure in the coming years it is particularly important to develop alternative financing routes, particularly for SMEs. These include:

- **Venture capital:** while the fall in lending in response to the crisis is understandable, the industry remains much smaller than that in the US. The Commission must support the industry's development as an essential source of risk finance and expertise for innovative SMEs.

- **Capital markets for smaller and medium-sized companies** remain underdeveloped, both for smaller bond issuance and equity listings, and we support initiatives that make both routes less costly for SMES.

- **Securitisation:** Restoring confidence in the securitization, particularly of SMES loans within a properly regulated environment, can potentially play an important role in allowing banks to free up their balance sheets and extend lending.

4. Promote tax systems which support long-term investment.

We welcome Commission recommendations, for example in the 2013 Annual Growth Survey, urging Member States to avoid taxes on capital and labour which are most harmful to growth. In this context, we believe the Commission should take the lead and withdraw proposals for a Financial Transactions Tax, which analysis has shown could lead to a 2% fall in company investment.

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5. **Ensure public funds leverage private investment**

We have been strong advocates of the need to focus more of the EU budget on long-term investment, in particularly on R&D through Horizon 2020 and on cross-border infrastructure through the connecting Europe facility.

What is now needed is to quickly implement an agreement on the multiannual financial framework for 2014 to 2020. Businesses need agreement and clear rules if they are to start developing investment programmes for the coming years.

In terms of achieving greater leverage of EU funds, we believe a number of the schemes being taken forward by the European Investment Bank have a key role to play. In particular, the EU project bonds initiative must be accelerated, and once we have learnt lessons from the pilot phase, hopefully taken forward further.

Yours sincerely,

(original signed by)
Markus J. Beyrer

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COMMENTS

25 June 2013

Long-term financing of the European economy

COMMISSION GREEN PAPER

Introduction

Access to finance is vital for companies and growth. It remains a major concern especially as constraints on lending and investment particularly affect long-term investment in capital intensive infra-structure such as transport, telecommunication, water and energy networks which are vital for economic growth but also to cover the financing of the retirement needs of an increasingly aging population, climate change, and education. BUSINESSEUROPE thus welcomes the green paper on long-term financing of the European economy also because it is addressing the broader picture of how the financial system can encourage growth rather than the narrower one of ensuring financial stability. BUSINESSEUROPE, representing businesses that use financial services and are therefore particularly affected by the policies in this area, supports this move of focus from stability to growth.

Financial market integration

As banks will continue to withdraw from on-balance-sheet lending as a response to new financial regulations, there is a significant risk that as economic growth returns, banks will be unable to meet companies' funding requirements on the desired scale. This problem is particularly important in Europe where companies depend highly on bank intermediation for their access to finance. Both demand and supply factors continue to have a negative impact on levels of new borrowing and investment by companies. On the supply side, interest rates charged for bank loans to businesses continue to diverge (depending on both the size of the business and the country where the business applied for bank loans) and terms and conditions under which banks are willing to lend remain very tight and are likely to stay so. Private-sector investment from other sources such as investment funds, insurance companies and pension funds also fell significantly during the crisis and is likely to stay subdued if the economic climate stays uncertain and following new financial regulations which increase the costs for capital and encourage more prudent lending.

Despite support from the ECB, lending costs continue to vary substantially across the euro area. While a small business looking for a one year loan will typically pay a little over 2% in Germany, Belgium or Austria, this compares to around 5% in Spain or over 6% in Portugal – if indeed the loan request is accepted. In Greece, the situation is even worse. It is essential that Europe takes action to address this fragmentation by urgently finalising and implementing the new single supervisory mechanism and progress towards a deeper European banking union, which includes strengthened resolution and deposit insurance schemes.

So financial market integration must remain a core objective. Not only because deeper and more liquid markets would act as a buffer in the face of financial turmoil but also because they are key for reducing the cost of financing whilst encouraging cross-border trade and investment.

Long-term financing

Long-term financing should not be defined too narrowly. The green paper takes quite a limited view of what "long-term investment" is and where it is needed. Often, the provision of finance on a short-term basis can meet long-term needs. What is regarded as long-term will also differ, as, for example, long-term for a small or medium-sized company would often be about five years, whereas for an infrastructure project it would be more than 25 years. This should be taken into account also to properly address the continuity of the financing chain for companies which is characterised by an inseparable link between short- and long-term financing. Focus should not be only on the duration of investments.

There should be a common, widely-supported definition of long-term financing. This definition should constitute an essential prerequisite for the development of reliable European statistics tools and, in addition to the elements set out above, its focus should not be restricted to physical investments such as capital goods. It is becoming increasingly important for companies to finance short-term assets (stocks, receivables) on a long-term basis. The same applies to property that, like other technical infrastructure, is crucial for a more sustainable economy. Supplying the property sector with capital is one of the key issues for an industry that contributes significantly to stabilising the economy.

As set out above, constraints on lending and investment particularly affect long-term investment in capital intensive infra-structure such as transport, telecommunication, water and energy networks which are vital for economic growth. Public investment in these projects is also reduced as governments struggle with high sovereign debt. Long-term investment is key for all aspects of economic growth, and particularly important to enable productive investments that will be essential for the recovery. Europe needs a regulatory framework that is more supportive of both the development and financing of long-term investment projects in areas such as energy, innovation and infrastructure.

In this respect, we agree with the green paper's main analysis regarding the role and characteristics of long-term financing and the need to improve and diversify the system of financial intermediation for long-term investment in Europe. Especially, the financial and prudential reforms will greatly change access to finance conditions. In spite of abundant savings, European economies continue to suffer from a lack of long-term financing. Fiscal and legal barriers to long-term financing should be removed to create a favorable climate for companies which facilitates their financing from savings.

The launch of the green paper is a first important step, but needs to be followed up by concrete initiatives that seek to resolve the insufficient financing of long-term projects. In particular, the Commission needs to consider the cumulative effects of all EU policies on the availability of finance for long-term investment, as well as the broader impact of policies on companies' investment decisions.

The role of banks

Businesses, and especially the smaller and medium-sized businesses, depend highly on bank lending. These companies need the availability of financing from the (international) banks that are active in the EU. These banks provide liquidity to the financial markets and are active in specialist financing and business niches. They need to be able to support EU business and the broader economy.

Although banks will continue to play a prominent role in long-term financing, their role may further change. In addition to the mere provision of loans, it is likely that more and more banks will increasingly play a role of adviser, broker or loan agent. Companies benefit from banking with diverse universal banks. They often need the balance sheet of such banks to support them, for example in the case of large infrastructure projects or when a debt or equity capital issuance has to be underwritten.

Considering the growing need for long-term financing and the reduced ability of banks to provide (long-term) credit, the EU should encourage more diverse forms of finance - including non-bank finance such as financial markets, debt securities, "district bonds", cluster financing. An important role can also be played by institutions providing guarantees.

Public development banks

Although public development banks play an important role for the long-term financing of small and medium-sized enterprises, in principle, the public sector cannot substitute for the private sector. Public operators should not be privileged and their activities should be ruled by European law principles. In principle, public development banks should not go into the direct lending business thereby entering into competition with commercial banks unless when there is a clear gap in the availability of finance. Considering that the funding landscape in the EU is deeply fragmented, there is also an urgent need for uniform eligibility criteria and standards for lending, not least to facilitate the financing of cross-border investments.

Of particular importance are promotional loans for the financing of innovation and investment in environmental and climate protection and energy saving. If development banks do not have the best credit rating, the refinancing of funding should be organised via the European Investment Bank to generate the most favorable terms for the borrower. It is important to maintain the so-called "house bank principle" in order not to harm relations with local banks.

EU loan programs - The SME definition

SMEs have expanded strongly in the course of internationalisation. Unfortunately, growth and innovation based medium-sized companies are not sufficiently covered by the narrow EU definition of SMEs. These companies, which are an essential engine of investment and employment in the EU, should not be excluded from access to promotional activities.

The role of other investors

Institutional investors, such as pension funds and insurance companies, normally pursue a long-term investment strategy. Unfortunately, the supply of financial resources by institutional investors is hindered by new prudential rules. For example, insurance companies will be unduly burdened with capital requirements following Solvency II. These rules need to allow for insurers to invest in infrastructure over the long-term without increasing barriers to investment. They should take account of the respective structures of assets and liabilities, given that long-term liabilities need to be financed by long-term assets. Also, the issue of appropriate risk evaluation is central for the correct calibration of the rules. The rules should reflect real risks.

Considering the important role that other investors can play as providers of capital, it is absolutely key that the regulatory framework does not prevent them from investing in private enterprises. This means that regulation should first and foremost be neutral and not grant any special privileges to government assets. The rules must also not hinder investors from playing a part in new forms of SME-finance which might emerge. The same applies for the implementation of any new reform measures in the area of "shadow banking" as they could also restrict the availability of finance to businesses. It is crucial that European rules that impact on the availability of alternative means of financing support market liquidity and make it easier for businesses to access debt and equity funding investments. Investors should be encouraged to invest long-term risk capital in European companies when we need such partnerships between European companies and long-term European investors to generate employment and economic growth. In order to promote institutional investors' financing of the real economy, publicly backed guarantees on corporate bonds should also be envisaged. These guarantees would allow institutional investors, especially pension funds, to reconcile the business of financing the real economy with the need to limit risk.

Financial regulation: cumulative effects

Safeguarding financial stability is crucial for companies. BUSINESSEUROPE supports smart regulation for financial services in response to the regulatory failures that led to the financial crisis and to address the risk of similar events occurring in the future. Reforms should combine financial stability with growth and be mindful of companies' needs to access finance and manage risk. It is thus important that financial market reforms strike the right balance between safeguarding financial stability and the financing needs of companies. Consideration should thus always be made of the impact on business and the wider economy of new reform measures and this should be mandatory for all impact assessments. What we need is smart regulation that is proportionate to avoid undue imbalances between costs and benefits and to devise rules that are clear and easy to apply.

BUSINESSEUROPE has always underlined the importance of comprehensive quantitative impact studies on the cumulative effects of any new rules which assesses both macroeconomic effects and the consequences on the financing of European companies. A number of legislative projects, both recently adopted and planned, have all an impact on financing conditions, such as rules on capital requirements, private equity, financial instruments, derivatives, measures to reinforce bank depositors' protection and financial tax and resolution schemes. For example, the proposed Financial Transactions Tax (FTT) will have a very significant negative impact on finance conditions as it will raise the cost of financing and reduce corporate investment possibly by at least 1.8%. The combined effects of these reform measures together with probably new rules in the area of "shadow banking" and accounting should not jeopardise European companies' access to financial markets on competitive terms and their ability to find long-term investors.

Financial markets

As banks and other investors are likely to continue to withdraw from lending as a response to new financial regulations, capital market financing is becoming more and more important for companies and especially the larger SMEs. There is a wide ranging set of finance tools that businesses can use to grow, some of which are more clearly long-term tools, and some of which are shorter-term (e.g. bonds, private placements, asset-based lending, peer-to-peer lending, crowd-funding). Further analysis should be undertaken to assess what exists and works well to identify how best to encourage growth in these markets on an EU-wide basis, particularly where benefits of scale exist. In this context, BUSINESSEUROPE supports a European framework for long-term investment that is embedded in a wider framework to support investment in the economy as a whole. Establishing uniform, high quality standards that do take due account of real specific risks is central to avoid the creation of bubbles and sustain confidence in these markets. Institutional investors should play a more important role on these markets to allow them to fill the SMEs equity gap.

Securitisation

Reviving securitisation markets would be an important contribution to strengthening long-term financing. The image of securitisation has suffered due to the lack of transparency of some financial products in the wake of the financial crisis, despite European assets performing very well from a credit and secondary market standpoint. The Commission should take initiatives aimed at ensuring a careful revival of securitization with a properly regulated framework and refrain from limiting money market funds to play an active role in these markets.

This will also require changes in prudential regulation that now clearly discourages investment in these asset classes through higher capital cost, such as Solvency II for insurance companies and the proposed "Revisions to the Basel Securitisation Framework" for banks. The proposed insurance rules make the long-term refinancing of banks and the transfer of risk from banks to insurance companies more difficult. Liquidity rules for banks (NFSR (Net Stable Funding Ratio) and LCR (Liquidity Coverage Ratio)) provide strong incentives for short-term investments and encourage investments in government bonds and covered bonds at the expense of corporate finance. Special regulatory treatment of securitization makes it difficult to transfer risk to insurance companies and to balance capacities between financially strong and financially weak banks, which will also have a negative impact on the long-term financing of companies.

Higher product transparency, strict quality criteria and an improved risk management of securitisation banks have already contributed to increased investor confidence. One positive example is the PCS initiative (Prime Collateralised Securities) based on clearly defined rules for transparency, disclosure, lending, and credit processing. Another positive example is the loan level initiative of the ECB and the establishment of a central European Datawarehouse for securitisation transactions under the surveillance of the ECB.

Project bonds

Projects bonds have the potential to be an important instrument for providing supplementary financing for large infrastructure projects, particularly of a cross-border nature. But while these bonds can increase the attractiveness of projects by allowing the EIB to absorb some of the risk, they will never make fundamentally unprofitable projects profitable. It is therefore important that the EIB looks to take forward projects where there is a realistic long-term probability of profitability. It is also important that regulatory decisions similarly reflect the need to attract long-term investment.

Taxation

From a tax point of view, long-term financing is best stimulated through efficient, predictable and stable tax regimes. Promoting long-term investment should therefore include the development of such tax policies in an inclusive way. Tax collectors and taxpayer considerations should be considered but also the goals European states want to achieve and how they can go about it.

BUSINESSEUROPE will support the development as well as the efficient implementation of such regimes. General tax rules are preferable to special incentives. Any need for a special tax treatment in an area, is an indication that the general rules are too restrictive. Therefore, a general reduction of the tax rate should be carefully considered. In case incentives are deemed necessary they should focus on improving the general business climate for capital investment, economic expansion and job creation, and be tied to achieving policy goals. The proposed financial transaction tax, which will raise the cost of capital and is harmful to long-term investment and growth, should be withdrawn.

While the tax treatment of the different sources of financing should be as neutral as possible to avoid distortion of investment decisions, equity-financed investment decisions remain significantly hampered in many EU countries by a corporate income tax system that present a strong bias towards debt over equity financed investments. Costs made should be considered deductible expenses. Therefore balancing the fiscal treatment of equity costs with interest costs should focus on enhancing the fiscal treatment of equity rather than impairing the fiscal treatment of interest costs. Different routes can be envisaged to revise the unfavorable tax treatment of returns to capital and unleash the potential for more equity-financed investments:

- Firstly, equity financed investments are generally subject to double taxation as equity taxation occurs both at corporation level and at shareholder's level. The problem of double taxation could be mitigated by reducing shareholders' taxes on dividends and capital gains. Also, in a globalized economy where the shareholder and the company often reside in different jurisdictions, the process of eliminating the so-called "imputation systems" in favor of the so-called "participation exemption" should be continued. Additionally, the measures provided by the parent-subsidiary directive to avoid double-taxation of cross-border profit distribution between companies of the same group should be reaffirmed and expanded outside of the EU. Finally, equitable tax treatment for private equity investment should be considered for large and smaller shareholdings.

- Allowance for Corporate Equity could also be a way forward as it helps rebalancing the tax treatment between debt and equity capital in allowing firms to deduct a notional interest rate on their equity. Italy has notably introduced in 2011 a scheme (Aid to Economic growth) which, in allowing deducting an amount equal to the notional return of equity capital increases from the taxable profit, proves to be a valuable tax incentive to finance investment through new capital.

- Nevertheless, it must be noted that a narrowing tax base resulting from a reduction for equity-financed investment at corporate level could result in an upward pressure on statutory corporate tax rates. It is important that the ongoing process of reductions of statutory corporate tax rates continue. It should be combined with tax reductions at the shareholder level.

-Ultimately, it must be noted that maintaining price stability is very important for limiting tax benefits to debt financing

A list of tax measures should be considered that can set the right incentives for long term savings and their orientation to corporation long term investment needs:

- A low level or the abolition of capital gain taxes on shareholders' long-term holdings would strongly incentivize long-term investment in corporate equity;

- It is also important to make sure that inheritance taxes do not interfere with the succession of SME as such a tax burden can force many competitive family-owned SMEs to close down.

- Finally, tax incentives for investors in venture capital would foster the financing of the creation and the development of innovative businesses, be it in the form of capital gains tax allowance, tax deduction or income tax allowances benchmarked to the amount invested.

Measures enhancing the functioning of the Single Market are increasing investments and growth and government coordination and cooperation is important to reduce red tape and delays in repayment of taxes.

Therefore, greater EU harmonization of administrative systems when possible, particularly for VAT, must be taken forward in a way that would bring less complexity and greater transparency to EU cross-border activities.

Accounting

The issue whether the use of fair value accounting principles has led to short-termism in investor behaviour is very complex. A company will always need stable funding. In order to prepare their investment decisions, providers of long-term financing (investors and creditors) are therefore more interested in information about profits, cash flows and risks in the business than in the fair value of assets and liabilities. On the other hand, some short-term investors manage their investments based on fair values of financial instruments (shares or other financial instruments) and for them information about fair values of financial instruments might therefore be relevant. Financial analysts and short-term investors who consider this to be the case are currently most heard in the accounting debate. Accounting standards should be tailored to favor the elaboration of financial statements including all necessary data for two types of investors. Financial reporting according to IFRS must remain a mixed model of two approaches; historical cost and fair value, trying to incorporate the views of both short-term and long-term investors and analysts bearing in mind the business model of the companies concerned.

One way of addressing the volatility problem in financial reporting may be to make a review of what unrealized profits of financial instruments should be reported in the P/L and what information about fair values of financial instruments instead could or should be presented in disclosures to the financial reports.

As for non-financial companies, we believe that information about fair values of assets and liabilities is less relevant for users of financial reports than information about profits, cash flows and risks in business. This view is firmly based on surveys with both investor relations departments in companies and financial analysts. Today an overload of information about fair values and financial instruments is required by non-financial companies that is not very useful, thus creating an excess reporting burden on those companies without corresponding benefits for users. Especially, the comprehensive disclosure requirements by IFRS may prevent private entities to opt for non-bank financing. We therefore believe that disclosure requirements should be significantly reduced for non-financial companies in order to help them and their investors focus on relevant information.

As for financial companies, long-term investors develop a specific business model whose main objective is to match as closely as possible assets and liabilities management. That specificity should be reflected in the financial statements.

As for short-termism in investor behaviour, this issue cannot be solved only by altering accounting principles. Instead, there is a need for a cross-cutting review of rules, regulations, standards, etc. for regulated investors and how those rules interplay with financial reporting standards.

SME financing

Companies, and in particular smaller- and medium-sized companies, must be able to diversify their access to finance. It will thus be necessary to support and encourage all new initiatives such as the creation of European bond markets for the financing of SMEs as these companies have little or no access to the capital market (corporate bonds). Currently, institutional investors rarely invest in SMEs which is a missed opportunity.

The barriers that prohibit direct access of SMEs to the capital market are numerous: a lack of liquidity of and high costs for issuing SME bonds (linked inter alia to the drafting of prospectus and related due diligence), high information requirements (especially the IFRS requirement on regulated market issues) and a lack of resources at the level of institutional investors to analyse the credit risk of small companies.

A number of initiatives have been taken to reverse this such as the creation of corporate bond trading platforms: the Stuttgart Bond platform, the First North Bond Market in Denmark and the Alternext market in the Netherlands. In Germany, those platforms only require local accounting rules as admission requirements to reduce accounting burdens for SMEs. Those experiences with specific accounting rules for listed SMEs should be taken into consideration by the Commission. At policy level, the Breedon report (UK, 2012) recommended to aggregate a large number of SME loans and finance them via the corporate bond markets and proposed to create an Agency (the Agency for Business Lending – ABL) that would be instrumental for this. In Italy, a Memorandum of Understanding has been signed between Confindustria, Consob and the finance industry for developing an array of measures supporting SME access to the capital market. Market creation measures should be aimed in particular at improving transparency of SME risks as well as reducing transaction costs involved in smaller volumes of SME issuance. For example, the creation of Enternext by Nyse Euronext, and Norway has introduced a trustee model setup which could lower the cost considerably for smaller corporate bond issues.

The Commission should promote dissemination of best practices and of advanced policy thinking regarding the establishment of bond markets accessible to SMEs and intermediate size companies.

In order to support the creation of European bond markets for SMEs, it could be beneficial to establish national rating agencies which might have a useful function to support SMEs in their credit activities as well as in issuing bonds.

Venture capital

Venture capital is a key financing tool from a macro-economic point of view. Venture capital accounts for 8% of private employment in Europe. But between 2003 and 2010, venture capital (VC) take-up in Europe has dropped from EUR 17 to EUR 3 bn. Pension funds and insurance companies play a very limited role as a source of finance for venture capital funds. This should be addressed to further offset the reduction in bank lending.

Other equity finance

For a particular class of small and mid-size companies, a public listing on specialized SME stock exchanges ("growth markets") is a logical option to grow their business. Yet listing has become more difficult in the EU, in particular because its cost has increased significantly in recent years.

BUSINESSEUROPE welcomes the Commission's intention to improve access to information about listed SMEs, thereby improving their ability to obtain financing. BUSINESSEUROPE also welcomes the fact that the Commission will reduce the burden on listed companies by eliminating mandatory quarterly reporting.

EU SME-geared financial instruments

The EU financial instruments for SME and mid-caps introduced under the CIP (Competitiveness and Innovation Program) and the 7th RTD Framework Program (FP) have demonstrated a strong leverage effect for stimulating the provision of credit and equity finance. Given this positive experience, it is essential to fund properly the relevant EU successor programs. Under the 2014-2020 structural funds, there is scope for deploying EU financial instruments (debt finance instruments, equity finance instruments and mezzanine finance instruments) on a broader scale. In certain countries, this should be done while improving the implementation of the EU financial instruments linked to regional policy.

In addition, the development of new European financial instruments under the European Investment Fund should be organized effectively so that national financial intermediaries can apply to become operator of the European financial schemes. The Commission should thus endeavor to promote synergy between capital instruments, respectively at national and European level, to develop a well functioning market for dept, equity and mezzanine capital.

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