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European Commission
Internal Market and Services DG
Unit 02
Rue de Spa 2 (3/020)
1049 Brussels
Belgium

Paris, 25st of June 2013

Dear Sir

Please find enclosed BNP Paribas' answer to the consultation on the European Commission's Green Paper on the long-term financing of the European economy.

BNP Paribas is particularly grateful for the opportunity to express its views on long term financing, as it is the main challenge for the near future in Europe.

A deep reflection on how the economic growth could be stimulated towards long term financing by means of regulatory policy would fit the current political debate among Member States on how the strict fiscal structural measures should be accompanied by actions to stimulate the economic growth.

Without a healthier European economy, investors would privilege investments in other jurisdictions.
Up to now, the main regulatory responses in Europe have focused on increasing the financial stability and making the credit institutions more resilient. The volume of new requirements encompassing all financial actors and products is quite impressive, and it is more than likely that the goals have been achieved.

Therefore, we applaud this initiative taken by the European Commission which should be followed-up by appropriate regulatory actions.

BNP Paribas group is keen to offer several avenues for reflection in the attached response and remains highly committed to take part this debate.

We stand ready to provide more detailed information to the relevant EC services in this regard.

Should you wish any additional information, please do not hesitate to contact us. Dominique Graber: +33 (0)1 43 16 90 02 / dominique.graber@bnpparibas.com or Laurent Quignon: +33 1 42 98 56 54 / laurent.quignon@bnpparibas.com

Yours sincerely,

Dominique Graber
Head of European Public Affairs

Paris, 21tst June 2013

Register of Interest Representatives:
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Green Paper on the long-term financing of the European economy

25st of June 2013

Response sent by 25th of June 2013 to:
markt-consultation-long-term-financing@ec.europa.eu

Contribution by BNP Paribas

BNP Paribas Group (www.bnpparibas.com) is a European **leader in banking and financial services**, with a significant and growing presence in the United States and leading positions in Asia. The Group has one of the largest international banking networks, a presence in over 80 countries and over 200,000 employees including: nearly 165,000 in Europe - among whom 18,900 in Italy, 18,000 in Belgium, 64,600 in France and 4,000 in Luxembourg. BNP Paribas enjoys key positions in Corporate and Investment Banking, Private Banking & Asset Management, Insurance, Securities Services and Retail Banking.

GENERAL REMARKS

BNP Paribas welcomes the opportunity to comment on the Commission's consultation paper on the long-term financing of the European economy.

Long-term financing is crucial for the sustainable growth in Europe. According to the G30 report on Long-term Finance and Economic Growth, by 2020, annual long-term investment in five mature economies and four major developing economies[1] will need to **increase to $ 18.8 trillion** in real terms to achieve even moderate levels of economic growth. This equals 34% of these nations' GDP, up from 30% of GDP, currently. However, resources are limited to meet this level of investment demand. Competition in order to attract new financial resources will be scarce.

Although banks are traditionally the main financial intermediaries in Europe, in line with the new regulatory framework proposed by the Basel Committee, the Green Paper takes for granted that **European capital markets would replace banks on a large scale in**

[1] Brazil, China, France, Germany, India, Japan, Mexico, the United Kingdom, and the United States.

providing finance to the European economy. This revolutionary shift would materialize by moving towards the originate-to-distribute model, which forms the basis for financing the economy in the US. This prospect is predicated on the false assumption that the main features of the European economy are similar to those of the US:

- 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 (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 GSEs.

- In 2012, in the United States, about 47% of mortgages passed through books of Government Sponsored Enterprises (GSEs) and this mortgages securitization involved significant public finance support. The GSE debt securities, which are the counterpart of the loans these institutions buy, are commonly described as "US agency" obligations, which are perceived by investors to be implicitly guaranteed by the US government despite explicit, legally prescribed denials in offering materials. However, pursuant to the voluntary conservatorship agreement of 2008, the Federal Government has purchased $ 187bn in special stock from Fannie Mae and Freddie Mac. In addition, the government holds $ 821bn in MBS issued by Fannie Mae and Freddie Mac. Moreover, the agreement requires Treasury to provide up to $ 274bn of additional funds, if necessary. Given the current budgetary constraints in the European Union, such a government support is neither probable nor desirable.

- The American external position was negative by 28% of the GDP at the end of 2011 against 14% for the EU which reflects the attractiveness of the US for all types of foreign investors. Moreover, over the last two decades, the US growth rate has been around 1% higher compared to the euro area and according to IMF forecasts the potential growth rate for the next five years is still higher by 1%. There is no chance that EU could fill the gap with the US in terms of external financing.

- A further difference lies in the fact that the US dollar is an international reserve currency. The majority of international trade activities are denominated in US dollars. Internationally, the US dollar also forms the largest part of central banks' foreign reserves baskets. The strong global position of the dollar makes the US economy more attractive for international investors. For the EU and for the Euro this is less the case. Consequently, over the past decade, the share of global FDI destined for the EU, has declined substantially, from 45% in 2001 to 23% in 2010, in favor of emerging economies.

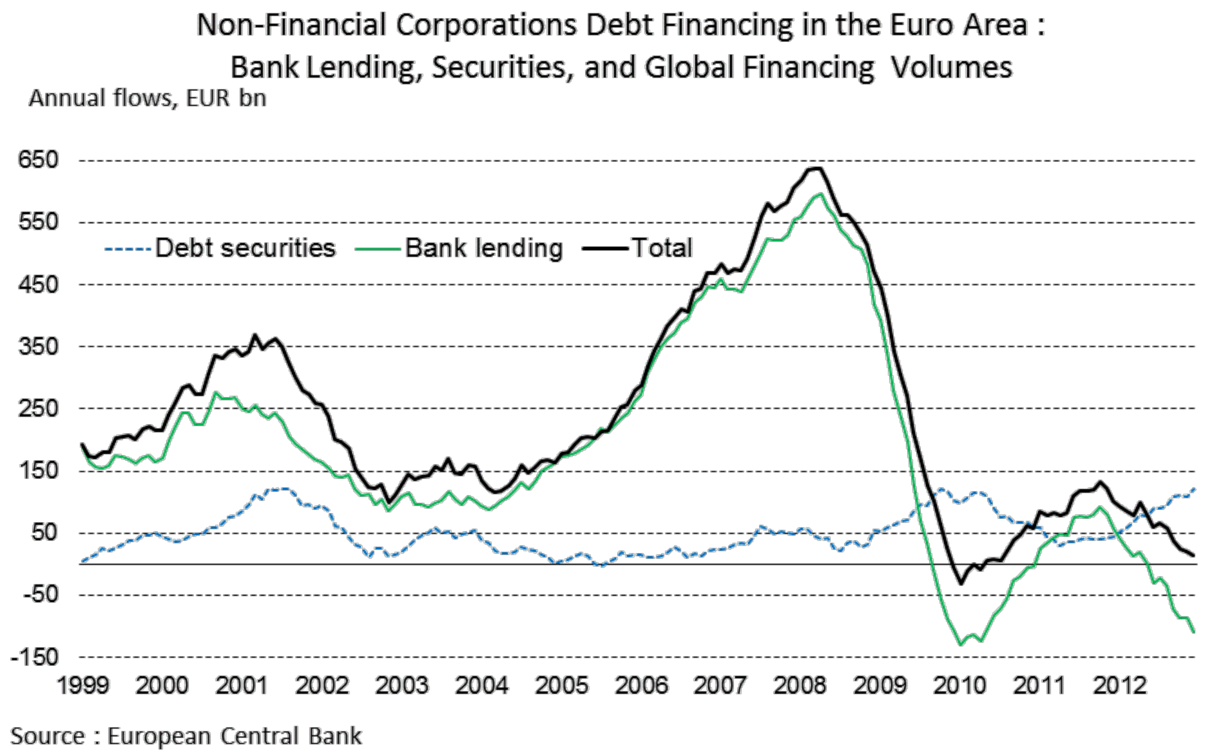
- The liquidity constraint management appears very different on the opposite side of the Atlantic and this has important consequences in terms of savings allocation. Although the details on maturities of household savings are not available in the Flow of Funds statistics, it appears that a substantially greater share of savings outstanding is allocated towards longer-term instruments in the United States compared to the euro area. Between 36% and 39%[2] of households financial assets

[2] ECB statistics indicate that EUR 522,9bn of MMF shares were held by euro area residents at the end of 2012 but the breakdown by institutional sector is unfortunately not published. Since the ratio of MMF shares

consisted of currency, deposits and money market fund shares as of Q4 2012 in the euro area *versus* only 16% in the United States. Conversely, the share of financial assets invested in securities and mutual funds other than MMF was far greater in the United States (80% of total financial assets held by households) than in the euro area (between 58% and 61%). At the same time and as a counterpart of a larger fraction of savings invested in long-term instruments, the recourse of households to borrowing is significantly higher in the US (109% of their Gross disposable income as of 31 December 2012, down from a pick of 167% at the beginning of 2008) than in the euro area (65%).

What made the development of the OtD model successful in the US is far less present in Europe. Consequently, the disintermediation - which took 20 years in the US - will be very slow in Europe and will by far not reach a similar proportion.

Furthermore, the empirical observation shows that total flows of **Non-Financial Corporations debt in the euro area are highly dependent on bank lending volume**:



Before the financial crisis, a certain degree of complementarity could be observed between changes in bank lending and net debt issuance, both moving in the same direction. The financial crisis marked a break, since the declines in bank lending were partially offset by expanding debt securities issuance. But the substitution has remained very partial and has not been able to compensate for the fall in bank lending.

outstanding to households' financial assets is rather small, we have made the alternative assumptions that euro area household held between 0% and 100% of these shares.

Those findings show that it is therefore imperative to <u>maintain, within a proper regulatory framework preventing the building-up of asset bubbles, the distinct and genuine feature of the EU model of the financing of the economy, i.e. bank lending</u>.

Consequently, the delegated act on the LCR, which is due to be adopted before the end of June 2014 should encompass high quality assets that are **eligible to central banks (consumer credits, residential loans, corporate loans) as liquid assets eligible to the liquidity buffer.** It would also mitigate the current inappropriate situation where the monetary policy of the European Central Bank is nearly inefficient

Capital markets are not a substitute of bank credit. They only channel pre-existing savings and should remain attracting to foreign long-term savings which could partially compensate the gap between needs and resources. Consequently, proposals such as the FTT as currently designed and a possible mandatory separation of the market making as a follow-up of the recommendations of the Liikanen report should be avoided. Both initiatives would hurt capital market functioning as they would kill the market making activity. In the same vein, a sound securitization including for SMEs has to be revived and all private initiatives with a view to enhance transparency and simplicity should be supported by the Commission.
The most realistic way to fill the long-term savings gap is to reduce public indebtedness in order to allow the reallocation of private savings towards productive areas more favorable to long-term growth. It is therefore imperative that **Member States press ahead with structural reforms**. This needs to go hand-in-hand with vigorous fiscal consolidation in order to mitigate the crowding-out effect of public debt, which is detrimental for private investment.

We must highlight that the role of private pension is bound to rise. There is indeed an increasing number of Member States which can hardly maintain the current level of public pensions due to the combined effect of ageing population and fiscal constraints. The present economic crisis is even worsening this trend of and materializes notably through a reduction of replacement rates for the revenues of employees compared to their wages before retirement. All in all, the need for higher complementary private pensions is raising, be it individual pension or occupation pension and this is particularly the case in Member States such as France where resources after retirement are currently very largely composed of public pensions. Therefore, the role of private pension providers will become more important in the future. Pension provision is typically a long term business and should be treated carefully in order to preserve its unique role in serving the needs of people at end-of- life and a proper financing of the economy. For that, an appropriate regulation with a long term focus is needed.

In the area of accounting, Europe should take the opportunity of the decision of the SEC to stop the convergence process between the US GAAP and the IFRS to reopen the reflection on the conceptual approach of the IFRS referential. The fair value model as a model *par défaut* needs to be put into question. Instead, the business model should be included in the conceptual framework and the concept of users extended to long-term investors.

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

We agree that long-term financing is fundamental to ensure long-term sustainable growth in Europe. This alone, however, will not be sufficient to put European growth back on track. It is therefore of utmost importance that long-term financing is coupled with vigorous fiscal consolidation and structural reforms.

We disagree with what the Green Paper seems to assume, namely, that European capital markets would partially and rather quickly replace banks in providing finance to the European economy. Banks, and banks alone, have the power to create money permitting them to create *ex nihilo* new resources and hence, savings. As capital markets do not create money, they can only channel savings. For that it is clearly important to revitalize capital markets and to avoid unnecessary constraints in order to improve the markets' capacity to remain attractive for foreign investors.

It is crucial that credit intermediation will be promoted in order to generate enough resources which could be turned into long term investment. In this regard, bank credit should remain the main form of financing the European economy, since banks are the only institutions which create long-term resources by maturity transformation.

Banks, given their proximity to the client and their understanding of the environment, are the best placed to make an objective credit assessment of SMEs and households. By definition, capital market investors with no direct access to the end-user borrowers, need to rely on a third party agent to analyze the credit risk of potential investments. In a bond scheme, this role is played by rating agencies. On SME or retail portfolios, rating agencies can only rely on a portfolio approach, based on a statistical analysis of historical default rates. We have seen in the US subprime crisis the flaws of such models, which missed the major change in credit standards which occurred due to misalignment of incentives.

Does Europe want to adopt the same path? This requires revitalizing the European securitization market (see below).

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

Long-term financing should be defined as a stable and productive investment, which is measurable over time. This type of investment would require the existence of sufficiently stable liabilities to be able to manage long-term assets without excessive liquidity risk. It is important to ensure that the analysis of the investment is combined with an analysis of its liabilities for enabling a long-term view.

It is necessary to be able to ensure a reliable and relevant measure of investment in order to be able to estimate the evolution of its level over time. This assessment must make it possible to evaluate its economic effects and to provide a decision-making tool for the public authorities. It is therefore important to establish a shared definition at European level, which will constitute a prerequisite for a reliable data tool with regard to investments and long-term financing. The establishment of data will refine the analysis of the financing needs and ensure long-term monitoring of the European policies in this field.

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 our calculation based on ECB figures, the euro area Monetary Financial Institution's balance sheets amounted to EUR 34.500bn as of Q3 2012, of which only EUR 8.500bn were long-term resources. Conversely, they owned EUR 19.500bn of long-term assets (loans, securities), meaning that they created EUR 11.000bn 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 appears to be inconsistent 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 the power to create credit permitting them to create *ex nihilo* new resources and hence, savings.

From an empirical point of view, the decrease of US banks' roles in the economy's financing has coincided with a deterioration of the net external position in the United States since the 1970s. More recently, the decrease in bank financing in the euro area was associated with a decrease in the global volumes of financing, confirming that the substitution of banks by financial markets remains only partial.

Excessive money creation leads to accelerating inflation or to financial instability while pumping-up asset prices. But insufficient money creation is also detrimental since it can lead to a contraction of money supply and an economic depression. The creation of "good money" is that which supports economic growth while financing productive investment.

In summary, we fear a decrease in the role of banks in the future, which may threaten the long-term financing of the European economy.

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?

We would like to emphasize, that the access to resources of national and multilateral development banks (MDBs) shall be granted under the same competitive conditions as for "traditional" credit institutions. It must also be ensured, that investments are done under the same prudential requirements than for the other players.

Long-term investment is a traditional mandate for national and multilateral development institutions, at European and worldwide level. Their role is fundamental as a catalyst to projects that would otherwise not be bankable by the private sector, and/or to provide comfort to private sector investors to enter in projects for which they may not have the local or sectorial expertise.
MDBs, thanks to their very high rating, have privileged and cheap access to capital markets, even in times of a crisis. As a result they have the capacity to play a counter-cyclical role in the financing of the economy, and to partially reduce the fragmentation within the euro area by allocating funds in a more optimal way.

Hence, we strongly support that MDBs get involved in the current project to revitalize credit supply in the euro area, in particular through the EIB/EIF. This is consistent with the recent recapitalization of the EIB as decided by the European Council in June 2012 as part of the Stability and Growth plan.

However, we believe that there are a number of challenges that need to be overcome to maximize the efficiency of their role, in particular with regard to SME funding.

Recent experience related to EIB's current SME lending scheme

BNP Paribas, as a bank active in several countries of intervention of the EIB, is a large user of EIB SME funding, and we are very keen to use this tool to maximize our capability to lend to SMEs in the countries where we operate.

The current scheme is a pure funding scheme, where the EIB funds the originating bank, and the bank funds the SMEs. The credit risk of the SMEs remains fully on the bank's balance sheet, and the EIB has an exposure to the originating bank.

As the Euro sovereign debt crisis developed, we observed that the EIB was constrained in terms of their exposure to the European banking sector. Except for some limited specific projects, the tenor of the loans is not long-term but rather medium-term (max 5 years). All the loan contracts with banks have embedded triggers linked to the threshold of rating agencies, thereby forcing banks to repay the loans or to post high quality collateral in order to secure the loans, if/when the rating trigger is breached. This implies, that the EIB is contributing to a pro-cyclical effect like any other interbank market participant, and that at this point there is no funding benefit for the originating bank.

In addition, banks will now be subject to the Liquidity Coverage Ratio, and the impact of EIB funding on LCR is actually negative, as banks have to assume that a downgrade may occur, and hence the EIB funding may be terminated or collateralized, while the SME loans are fully committed by the bank until maturity.

We currently have discussions with the EIB to find better ways to reconcile EIB's legitimate concern to protect the quality of its risk portfolio and the need to avoid worsening the systemic impact of rating agency downgrades, which goes against the policy objective of reducing fragmentation.

Recent evolution of EIB's portfolio

This pro-cyclical position is also illustrated by the transmission of the fragmentation trend to European SMEs. Actually, because of the strong correlation existing between a given sovereign risk profile and its banking system, the SMEs located in peripheral countries suffer from very expensive funding costs. In this context, the EIB reveals unable to smoothen this phenomenon. Because of its traditional funding mechanisms (intermediary loans, or direct funding through project finance) it is driven by credit risk considerations similar to other commercial banks. As such, in 2012 the breakdown of the total project lending was for peripheral countries:

- 4.6% for Portugal (vs. 5.1% in 2011),
- 12.4% in Italy (vs. 12.4% in 2011),
- 3.4% in Greece (vs. 3.5% in 2011), and
- 15.2% in Spain (vs. 15% in 2011).

Exposures to peripheral countries decreased or remain stable, over an increased total envelope from EUR 481.4bn to EUR 495.3bn (+3%).

New potential frameworks

Whereas the EIB has no mandate so far to take direct credit risk on SME portfolios, the EIF has traditionally been able to provide credit enhancement or guarantees.

Securitisation transactions, where the EIF could guarantee/invest in the mezzanine or Equity tranche (and EIB in the senior tranche) could appear as a new orientation to permit EIB to both fulfil its mandate, and manage its credit risk.

We understand that the ECB has started a dialogue with the EIB/EIF in order to study how the EIB/EIF might contribute to a framework designed to restore a proper transmission of monetary policy across the euro area.

In this context we believe the framework should have the following characteristics :

- **Allow for the all-in cost to be passed on to SME's to be as low as possible, and not biased by sovereign spreads which create a distortion in competitiveness across the euro area**
    - This can be achieved through liquidity provided by the EIB and/or the ECB on a large part of the portfolio (a senior tranche ?)
    - In order to avoid weighing on EIB funding costs, the EIB could also refinance through the ECB discount window, to which it has access
    - In this hypothesis, the ECB would face the EIB rather than have direct exposure on the underlying SME assets or the originating banks

- **Provide originating banks with both funding and capital relief**
    - This implies to combine the risk taking capabilities of the EIF and the funding capabilities of the EIB and/or the ECB
    - Subject to prudential rules applied to originators of securitizations to be properly calibrated (see Arbitrage Free Approach proposal for details)
    - Potentially, provide also true sale recognition in order to help the banks to meet the future leverage ratio

- **Act as a catalyst for private sector investors to fuel the framework**
    - In order to leverage the limited capacity of EIB/EIF, and to allow the framework to have meaningful impact at European-wide level
    - Requires some credit enhancement from European AAA agencies in order to restore confidence from investors and achieve tight spread on the instruments
    - Given newly proposed rules on securitization, banks will not be natural holders of this paper, even at senior level

- **Provide transparent and reliable credit assessment**
    - Although some investors, notably in the equity/mezzanine levels may be open to invest without an external rating, demand for these instruments will be more sizeable if there are external ratings
        - The issue in this case is that rating agencies typically apply a sovereign ceiling in their rating methodology, which would prevent to achieve the fundamental policy goal of de-fragmentation. This further emphasizes the importance of a credit enhancement by a European institution
    - Given the legitimate pressure to reduce dependency on rating agencies in general, it would be highly desirable to design a framework which could provide this transparent and reliable credit assessment in a different manner:
        - Use of local rating agency ratings, or rating systems developed by the National Central Banks such as Banque de France. As long as these rating systems have been validated as ECAIs, they may be seen as qualifying to support the framework

        - This could be accepted at the level of the ECB, and could help domestic real money investors if there is a domestic incentive to invest. However, the absence of an internationally recognized rating will be an obstacle for many asset managers, whose investment policies are explicitly based on rating guidelines
        - Use of IRBA ratings as a basis for the credit assessment: unfortunately, not all banks have adopted the advanced approach, and even for those having implemented this approach, there remains some doubt in the investor community, also fuelled by several reports and statement by the regulators, that risk weights may not be equally prudent in all jurisdictions. We believe that increasing the credibility of risk weights is an essential goal to restore the credibility of the financial sector as a whole, well beyond this issue of reviving securitization. In this context, we believe that the implementation of the Single Supervisory Mechanism is a very important step, and that the Asset Quality Review process that should be conducted ahead of its implementation may be a good opportunity to harmonize credit risk assessment review and IRBA validation practices across Europe. In the longer term, a harmonized scoring system across NCBs would certainly be very valuable to support European wide securitization, but also factoring and intercompany credit

- **Avoid moral hazard: as in all European rescue mechanism, moral hazard is a legitimate concern for investors and for European institutions**
    - The originating bank would have to keep a portion of the first loss
    - Additional comfort, and capacity, could be obtained if the European institutions would partner with national development entities and co-invest in a risk sharing scheme. This commitment by the national entity would also provide some comfort to investors

- **Channel those funds to the financing of new loans**
    - This may rise some issues in designing eligibility criteria, rather than analysing an existing performing portfolio, whose performance can be assessed more easily. The uncertainty linked to the characteristics of future origination may bring additional costs and complexity, compared to securitization of an existing portfolio with replenishment (EIF has experience of such transactions)
    - If the framework allows banks to free up liquidity and capital on existing portfolios, from a policy standpoint, some conditionality may be needed to make sure that this liquidity and capital is reinvested into the SME lending business

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

The EIF is a prime provider of credit enhancement to catalyse SME lending. For SME, sharing the risk taken seems to fit better with financial intermediary's preoccupations than providing liquidity.

EIF guarantee operations can be broadly split into 'own risk' and 'mandate' activities:

- For own risk transactions, EIF employs its own capital to credit enhance tranches of SME loan or lease securitisation transactions and to provide guarantee cover for SME loan and lease portfolios to financial institutions on a bilateral basis.
- As part of its mandate activity, EIF manages the SME Guarantee Facility (SMEG) under CIP on behalf of the EC. Under this facility, losses are covered using the EC budgetary resources specifically allocated to this programme. The guarantees and counter-guarantees issued cover part of the expected loss for portfolios of SME loans or leases originated by financial institutions.

Total outstanding guarantee commitments amounted to close to EUR 4.4bn in 221 transactions at the end of 2011. Of this total, EUR 2.9bn were dedicated to own risk and EUR 1.5bn to mandate programmes, mobilising more than EUR 30bn.

Throughout 2011, EIF continued to be an active participant in the still evolving SME securitisation market. The total volume of guarantee signings in the securitisation space in 2011 amounted to EUR 932m and supported SME lending volumes of EUR 4.8bn.

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

The landscape of long-term financing, provided that it ensures enough return and safety, presents numerous opportunities for long-term investors, given their willingness to diversify their portfolios. For instance, the possibility to develop investments in infrastructure, which can offer recurring returns, has to be analysed deeply in order to be sure to have secured investments. These types of investments can benefit at the same time investors, including final beneficiaries such as pensioners, as well as the broader economy.

With regard to the types of investments that could be particularly supported, the European Commission has, in the context of the preparation of the Solvency II regime for insurers, asked EIOPA to propose adjusted calibrations of capital requirements for investments in certain asset classes. The draft answer submitted for consultation by EIOPA was disappointing because it gave globally negative feedback due to insufficient quality or quantity of data. We understand the position of EIOPA from a purely technical point of view because when analysing data, it seems possible not to conclude either way for or against adapted calibrations. In fact, the real question which needs to be posed is, whether the European Union wants to favour long-term investments by European investors, or not and it is up to the Council and European Parliament to give a political answer on the investment policy of the European Union based on European Commission proposals. Those institutions need to keep in mind that if European institutional investors are to be prevented from long-term investments, it is difficult to predict by whom they would ultimately be replaced (foreign sovereign funds, insurers or pension funds from countries were prudential rules are less constraining).

More generally, we suggest to take into account a statement from the Group of Thirty "G30". In their report entitled "Long-Term Finance and Economic Growth" it is stated, that "policy makers must consider the systemic impact of ongoing and future regulatory changes on long-term investment. Failing to do so could result in today's modest unintended consequences becoming tomorrow's much larger real economic problems".

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?

Prudential regulation for insurers

Regarding the design of Solvency II, it was agreed in the trilogue end 2012 to launch a Long-Term Guarantee Assessment (LTGA) because of the perceived difficulties to manage excessive volatility of the solvency ratio. The first results appear to confirm the concerns that without appropriate and wide counter-cyclical tools the new regime would not work correctly. These tools need to be predictable (even if exceptional events could trigger additional reactions from supervisors) and deal with the diverse features of insurance contracts in different Member States.

Relationship between insurance and IORP prudential regulations

We believe that the same issues of long-term financing arise for insurers (especially those which activity is dealing with private and occupational pensions) as well as for IORPs: both have long-term commitments. Both prudential regimes have to be consistent and treat each type of pension scheme according to its specific risk features while applying the "same risk - same rules" principle. Under this principle:

- It would be premature to consider applying Solvency II capital requirements for occupational pension schemes as they are not yet finalised regarding the long-term guarantees issues, which are the core of the pension business. Solvency II will however set the benchmark as soon as it is concluded.
- When setting quantitative capital requirements to occupational pension plans, the level of these requirements should take into account the specific nature and maturity of occupational pensions.
- Until an agreement is reached on the opportunity and means to introduce capital requirements on pension plans, we recommend that occupational pension schemes managed by insurance companies remain under the current Solvency I regime.

Prudential rules in general

We want to draw your attention to the conclusions of an OECD working paper on finance insurance and private pensions ("The effect of Solvency regulations and accounting standards on long term investing: implications for insurers and pension funds", November 2012 (Clara Severinson, Juan Yermo). This report reviews recent as well as planned changes to accounting and solvency regulations affecting insurers and pension funds and how they may impact long-term investing by these institutions. The review of existing evidence focuses mainly on the impact of risk-based solvency requirements, identifying instances where such regulations may have driven changes in investment strategies and potentially led to pro-cyclical investment behaviour such as the fire-sale of assets in market downturns. The report concludes with a note of caution regarding the application of strict fair value and risk-based solvency rules.

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

In allocating their savings in non-risky and short-term products, investors do not benefit from the risk premium offered by longer-term assets. This lack of optimization in the allocation penalizes the growth potential of the economy.

One suggestion could be the creation of a long-term savings fund that is intended for retail and institutional distribution. Based on the UCITS IV Directive, its regulatory framework would ad-just certain criteria in order to better meet the specific long-term while preserving the UCITS approach which has demonstrated its robustness. This long-term productive savings fund would:

- Offer a new channel of financing to the economy by widening the scope of eligible assets: non-listed companies (stocks and bonds), debt securities business (corporate loans), infra-structure financing, etc.
- Facilitate the redirection of savings towards productive investments through the eligibility of products subject to a wide underwriting environment (life insurance, employee savings plans, etc.)
- Respect the UCITS pillars ensuring:
  - Guarantee of quality and robustness
  - Transparent framework
  - Distribution to individuals like the institutional segment
  - Possibility of European distribution in the future

European companies need new financing solutions. The scope of eligible assets in UCITS IV is restricted to listed securities. The current framework already includes bonds and other debt securities. The new framework should make eligible non-listed securities or those which are traded on a regulated market.

However, changes in the scope of eligible assets require an adaptation of liquidity constraints and valuation rules to allow a better consideration of the owners of the underlying portfolio. Non-listed securities do not benefit from the same liquidity as other assets. It is necessary to protect holders to ensure the stability of the fund during the redemption period. In order to facilitate the liquidity management of the portfolio during the application for repayment, it could set up systems of a notice period of one month.

Liquidity adjustments:

The liquidity of an asset is associated with the difference between the purchase price and sales (range bid/ask). Today, a new method of valuing funds emerges and is recognized by regulators: the "swing pricing". This method allows the valorisation to marking to mid-price between the purchase price (ask) and sales (bid) of all fund assets. The subscription of the shares will be carried out at the cost of purchase of the funds (ask) and the refunding of the shares at the cost of sales of the funds (bid). This "fair" value would be to the cost of liquidity to incoming and out-going while fully protecting the rest of the holders.

Valuation consideration:

The daily valuation becomes a source of misunderstanding in the case of long-term investment. The disclosure of the fund's net asset value in official documentation might prefer an expert value approved by an auditor. The assessment would be published monthly. It would therefore be less volatile and consistent with the spirit of long-term investment.

Tax issues

With regard to the tax rules applicable to income or dividends distributed to a pooled investment vehi-cle, these rules should enable investors to benefit from advantages provided by a double tax treaty. This would be concluded between their home Member State and the country where the issuer's assets are established in which the investment vehicle has invested.

Taxation rules that will be set up by Member States will also be important for investors to be interested enough to invest long-term.

European passport

The investment vehicle should benefit from a European passport provided that asset managers comply with the requirements similar to those laid down in UCITS and AIFMD - with particular regard to risk management, the independent valuation principle and transparency to investors and competent authorities. In order to ensure investor protection, the investment vehicle should appoint a depositary located in the home Member State of the fund. The depositary should:

- ensure the safekeeping of assets (custody and position keeping for assets that cannot be held in custody),
- verify that the long-term investment policy is compliant with the vehicle's investment rules dis-closed to investors or members.

Eligibility of the investment vehicle

The national regulatory framework for insurance companies and IORP should be reviewed to make this vehicle eligible.

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

As explained in the answer to question 3, prior savings must be available to be channeled through capital markets or other financial instruments to finance short or long-term investments. Consequently, bank money creation and transformation must be maintained.

The two standards[3] developed by the Basel Committee for funding liquidity will mechanically limit banks in their transformation capacities. Altogether, holding long-term assets will be penalized 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.

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

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 nearly inefficient (since huge 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 these excess liquidities, monetary policy becomes almost inefficient, as the ECB can only decide to sterilize a large quantity of these liquidities.

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 the liquidity buffer that are eligible to central banks and which represent sound financing of the real economy.

Concerning the Net Stable Funding Ratio (NSFR), the observation period (which is set to last until the end of 2017) should be fully used 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 affect this euro of long-term resource to activities other than credit to the private sector, as this euro of resource would also permit to finance either 20 euro government bonds, or between 2 and 5 euro corporate bonds.

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?

Since the summer of 2010, the Institute of International Finance (IIF), the BIS and most recently the OECD have published reports on Basel III's economic impact. At first sight their conclusions appear to differ. But they more or less agree on the transmission mechanisms involved – which is the key part – even though their methodologies diverge considerably.

At the BIS, research on the macroeconomic impact of Basel III has been conducted by two separate working parties. The Macroeconomic Assessment Group (MAG), which brings together experts from 15 countries' central banks and regulators as well as from international institutions like the IMF, BIS and FSB, was asked to evaluate the costs associated with the new prudential framework during the transition period. On the other hand, the Long-term Economic Impact Working Group was asked to examine the long-term benefits of prudential reform, assumed to be a smaller probability of banking crises and associated GDP losses as well as more limited fluctuations in GDP outside crisis periods.

Any assessment has to start with a calculation of the increase in the average cost in banking resources implied in increases in capital and the extension of the maturity of bank liabilities stemming from Basel III. This step implicitly raises the question of whether the Modigliani-Miller theorem (cf. infra) can be applied to banks. The following steps consist of quantifying the impact of more expensive bank resources on bank loan rates and lending volumes, either successively (the IIF) or simultaneously (MAG). This impact is then translated into economic growth. While this result is what the IIF and OECD are aiming at, it is another point of departure for the BIS, which considers the effects of (assumed) greater financial stability on growth.

In contrast, the methodological approaches used to identify these macroeconomic effects have very little in common. The IIF has simulated the incidence of the new rules on aggregate bank balance sheets for each major economic area, adjusting for the different components of balance sheets and income statements, and used elasticities generated by its own econometric estimates. The BIS largely dispensed with this intermediate stage regarding changes in bank balance sheet structure, relating the increase in solvency ratios directly to the cost of credit via median elasticities derived from 97 economic models concerning different geographical areas. For each intermediate step, the BIS experts used the median elasticity obtained from an array of empirical models testing a comparable relationship. The macroeconomic impact study is based on transmission mechanisms similar to those used by the BIS. Tougher capital requirements and new liquidity rules make banking resources more expensive and lead to an increase in the cost of bank financing then a decline in its volume. The IIF also assumes that banks seek to compensate for the opportunity cost linked to holdings of liquid assets for LCR purposes by increasing their lending spreads. And that results in a slide to the bottom end of the economy's growth track.

While the IIF study turns on the impact of the new rules on the banking system's balance sheet, the BIS looks at these effects via a series of models that generates a wide variety of results. It then retains the median of these effects. According to the Institute of International Finance in its final report regarding the "cumulative impact on the global economy of changes in the financial regulatory framework" (September 2011), the latter will translate into a loss in input amounting to 0.7 percent per year between 2011 and 2015 (-0,6% in the euro area, -1,1% in the United Kingdom). Of course, the cycle of GFCF is closely linked to the global economic cycle since the Gross Fixed Capital Formation (GFCF) is a major component of the GDP (18,4% of the EU-27 GDP in 2012), but also because a buoyant economic activity, which supports business sector margins, and a favourable outlook are known as the key drivers of productive investment. The ratio of GFCF to GDP has followed a broad although not continuous downward trend since 2000, from 21,1% in 2000 to 18,4% in 2012.

Moreover, the changes introduced by the prudential reform will result in a distorsion in the debt outstanding towards shorter maturities, which may penalize both the global volume of financing (the lower the maturity, the higher the financing constraint on business cash-flows) and, more specifically, the financing of long-term investments. These factors should contribute to dampen productive investment and are likely to limit the scale of any potential economic recovery. Lastly, a lower growth rate tends to deteriorate the credit quality, from a structural point of view, and to limit both the financing capacity of banks and the appetite of investors for risks.

The authorities should therefore strike the right balance between the limitation of the systemic risk, the strengthening of the robustness of financial institutions (all the more so because a number of well diversified European banking groups have shown their resilience during the crisis) and the financing of the economy which is inseparable of the acceptance of a certain degree of risk (including that of liquidity risk associated with maturity transformation).

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

In order to channel long-term financing as effectively as possible, capital markets need to be well functioning. This requires efficient client facilitation via liquidity provision and the availability of appropriate hedging solutions, whereby the role and engagement of market makers are vital. Market makers are essential for efficient capital markets. They provide liquidity, which ensures a two-way market where transactions can easily be reversed at a reasonable cost, at any time.

The relationship between primary and secondary markets is pivotal. The secondary market is used as a benchmark to price new issuances. This means that an active, liquid secondary market will make it easier to place new debt in the primary market: it will offer better access to finance at a lower cost for the issuer, as the investor will be more comfortable to invest knowing that he can always rely on secondary liquidity if needed. Hence, market making is crucial to safeguard the link between issuers and investors.

Regulators have introduced a number of new legislations to make financial markets more efficient and effective and to reintroduce financial stability. We observe, however, that these reforms have significant cost implications for transacting and hedging, affecting not only market makers in their capacity to adequately fulfil their role, but also end-investors in their decisions.

Financial market reforms, as currently being introduced, will reduce systemic risk in the financial system to a large extent, foster market integrity, and thus contribute to reinstalling consumer confidence. As such, they will have an impact on the investor's decision whether or not to invest in the long-term. At the same time, these reforms have a significant impact on the cost of transacting and hedging, add complexity and create extra operational and administrative burdens:

- 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 significantly step up the cost of hedging via OTC derivatives, impacting the return on investments
- MiFID II, currently still under negotiation, will reinforce sound customer protection, improve market infrastructure and enhance pre- and post-trade transparency requirements. The latter should be calibrated very carefully though, in order not to hamper market makers in their capacity to provide liquidity, especially for non-equity products
- The Short Selling Regulation aims to reduce speculative market activity and reinforce market integrity. However, it allows market participants to buy EEA sovereign CDS only if they have exposures that are "meaningfully" correlated with the relevant sovereign debt. This makes the use of sovereign CDS as a proxy for hedging exposure in a country much more difficult. As such, it reduces international investor appetite in the bond market of smaller European countries and adversely impact debt issuance levels

Whereas these reforms do contribute to a safe and sound market environment, they also pose a challenge to long-term finance initiatives, as they make hedging less economical and more burdensome. This could deter investors from hedging, which would increase risk in the financial sector again, or from providing funding all together.

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 deliverability and consistency, through a stronger pipeline of projects, helping to make the process more efficient and more predictable;
- Given the demise of monocline 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 if Europe is to attract FDI given the estimated 80% of pension assets and 70% of insurance assets 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.

Tax reforms, such as the proposal to introduce a Financial Transaction Tax in a number of European countries, aims at reducing short-term, speculative trading. The scope of the FTT proposal is extremely wide and is likely to have a significant impact on the cost of financing through capital markets as it will make transacting and hedging much more expensive within the FTT zone. Consequently, it will lower the return on investment and drive international investors away from investing in the countries involved. As such, it will have an impact on the investor's decision as to where to invest. This initiative seems counterproductive to the intention of stimulating long-term financing, where tax reform could actually be a very meaningful tool to incentivize investors to engage in the long-term in Europe.

On structural reform, such as the upcoming response by the European Commission to the Liikanen report, may envisage moving trading activities into separately funded and capitalized entities. We doubt that this exercise would meaningfully reduce systemic risk any further, given all the regulatory steps taken in that direction already. Moreover, it would significantly step up the cost of funding of the separated entity, again making trading and hedging activities much more expensive with the entities concerned, as such reducing market liquidity, competitiveness and return on investment. A clear view of the cumulative impact on the real economy of regulations already in place is essential before moving to further structural reforms. This will help the banking sector to fully support and develop the potential of capital markets as a source of long-term financing.

New regulations put in place will have a beneficial impact on market stability and market integrity. At the same time, they come with a significant cost impact on transacting and hedging, which could adversely impact long-term investment decisions.

The cumulative impact on the real economy of the current regulatory initiatives should be carefully considered. This will help the Commission strike the right balance between the contribution to stability on the one hand and the cost of reform on the other hand, without hampering long-term growth in the meantime.

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?

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 area and the equity gap has been widening over the last twelve years (345% in 2012 after 353% in 2000 for the United States against 272% in 2012 after 288% in 2000 for the euro area).

Besides, the hierarchy in terms of dividend yields has remained more or less the same over the last 20 years. The Japanese and American firms display one of the lowest levels. Most of the European competitors (and especially, the German, Italian, French and Spanish ones) in their turn show clearly higher levels. In addition, European companies, by contrast to American and Japanese ones, tend to stabilize their dividend levels during periods of deterioration of the economic situation by increasing their pay-out ratios (as it may be observed in 1988, 2001, 2008 and 2011). Contrary to the United States' firms for which stock buybacks are a common practice to deliver yield to shareholders, European firms prefer to give back cash but these high dividend payouts in cash penalize their self-financing capacity. For instance, the self-financing rate of euro area companies is historically lower than the one of their American peers (on average for 2000-2012, 87% for the euro area against 110% for the United States).

Taking into account the higher 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 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 reducing at the same time the observed equity gap.

Even if there is a high potential for direct funding via capital markets, the role of banks as a lender will not fall away overnight. Especially for smaller enterprises, for which direct capital market access may prove difficult, bank loans will remain an important source of finance. Public policy should support bank lending to smaller corporates, as well as the securitization of these loans and the investment in these securitizations. For example, lower capital charges could be envisaged in this context.

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.

In addition to the development of the market segments mentioned above, market-based intermediation could be changed via adapted accounting standards and tax regimes. These could be meaningful tools to encourage long-term financing. Accounting standards could be reviewed to differentiate between long-term and short-term asset holdings, reducing short-term volatility in investment portfolios, thus incentivizing long-term investment. Tax measures could favour financial savings over non-financial savings.

When 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.

<u>Keeping in mind that bank lending must remain the major source of financing of the European economy (see question 3) there are some benefits in the development of a new Originate to Distribute (OtD) model</u>

Regulators and market participants acknowledge its importance to get the real economy back on track. OtD 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, project finance etc, as long as long-term resources can be mobilized. It will increase the availability of long term credit at affordable levels as long as originators needs match with investors' expectations. Lower funding costs will make sure that they can expand their business and keep their competitive edge. At the same time, it will allow them to diversify their ways of funding and reduce sole reliance on bank credit.

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 without increasing leverage on their balance sheets.

OtD secures the commercial relationship that banks have with their customers. Banks can use their expertise and market presence to offer specific solutions and match funding needs of borrowers on the one hand, with interests of investors on the other hand. Their large customer network will allow to channel financing between both local and global counterparties.

OtD secures the investors also. Indeed, banks are specialists of lending and managing risks. We think that in the interest of the financial system stability, it is fundamental to leave credit origination to banks; it is their expertise and they are regulated accordingly.

We want to emphasise that the source of the 2007 crisis was in the United States, where many loans were originated outside of banks, and that banks were only intervening later in the process in order to package loans before selling them.

Furthermore, it is precisely because of the number of intermediaries between borrowers and banks increased while they were not required to retain a portion of the risks they were transferring that the credit risk quality deteriorated. It is paramount to prevent the origination of loans and the subsequent monitoring of credit risk from being completely removed from banking activities.

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 service in the secondary market via their fixed income platforms.

As such, risk allocation in the market is improved: risk can be efficiently channelled according to the investor's risk appetite, yield preference and risk management capacities. Next to that, OtD opens up a number of new possibilities to diversify risk and provides wider access to new asset classes.

Even if securitization is a powerful financing instrument, we notice that it is picking up only very slowly. We see three reasons for this:

First, the current economic environment does not inspire confidence yet. This is reflected in a low demand for credit and, at the same time, vigilance from investors when it comes to engaging money in the long-term, given current low inflation and low yields.

Second, long-term refinancing operations (LTRO) by the ECB have taken away some pressure from banks in their process of deleveraging. As these operations aim at maintaining a cushion of liquidity for banks holding illiquid assets, it is slowing down the development of OtD.

Third, the lack of regulatory certainty due to on-going regulatory proposals for securitization lessens the demand of investors for this asset type.

Taking investors' concerns into account, the OtD model will be geared towards securitization in a more simple form, focusing on more transparent, easy-to-understand structures.
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 set-up loan funds, co-lending agreements between banks and investors, and consortia backed by banks funding multiple projects simultaneously.

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

It will be crucial to maintain a level-playing-field between all actors involved, banks as well as non-banks. Therefore solid governance and regulatory supervision will be key in order to safeguard market confidence and avoid that past mistakes re-emerge among non-banks.

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

A 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.
Another idea could be the creation of a specific institution (like CRH) at the European level (it could also be a part of the EIB) that would borrow on financial markets and lend to banks, secured by specific collateral type (it could be asset classes that are not eligible according to national laws or CRD).

Nevertheless, one has to bear in mind that 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, Canada.

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?

The identification of the linkage between maturity (and also liquidity) transformation[4] by the financial system and its financial stability is accurate: maturity transformation could be a source of systemic risk, while weakening the stability of the financial system. On the other side, the maturity transformation is an important function as it permits the real economy to finance long-term projects, investments (credit liabilities) while holding short-term financial assets. Within the financial system this role is accomplished by various actors, belonging to and outside the banking system. We need to point out that the essential drivers of the financial stability are complex, given the complex interconnected system[5] of credit creation. Restrictions on maturity/liquidity transformation aiming at increasing financial stability should rely on an appropriate regulatory oversight and on a common approach for identical risks that different financial entities run (e.g. MMF's, hedge funds, etc.) and are potentially covered by distinct regulations. Regulators have already addressed the stability of the banking systems mainly through the following measures: higher capital and liquidity requirements, thus limiting the extent of maturity transformation; lender of last resort through liquidity insurance provided by central banks and deposit insurances schemes.

The financial system landscape involves a complex interplay between banks and non-banks, and between traditional forms of lending and securitisation. The role of securitisation cannot be insulated and in turn it is affected by a large number of factors. In the meantime, we should recall that securitisation is a financing technique that supports an economic function (such as key source of long-term financing for banks).

Therefore, as it is not an economic function in itself, one-fits-all rule for all securitization types, irrespective of the function they perform and/or the risks they generate seems to be erroneous. As such, the comparison between EU and US securitisation markets perfectly illustrates this point. For instance, according to S&P, US RMBS displayed a default rate of 15.6% between mid-2007 and mid-2012. The default rate for European RMBS in the same period was only 0.07%. Despite the fact that it displays none of the problems that underlay the sub-prime crisis in the US, the EU securitization market suffers from lingering reputational problems initially caused by the US sub-prime crisis.

In addition, while most of securitised assets in the US are redistributed, in the EU, two forms of securitisation prevail: securitization that is retained on the balance sheets of the originators and used for the purpose of their refinancing and securitization meant for distribution (originate-to-distribute). At present, only around 20% of structured products issued in the EU is placed, the rest is retained by the originators. In either case, the EU has robust rules in place to ensure that the quality of the underlying is high, and that banks retain a portion of risk as a way to align incentives along the securitization chain. This skin-in-the-game has not been the approach of the US originators, which led to poor quality origination and to overexposure to the subprime market.

The regulatory measures to enhance the recovery of securitization in the EU are already in place, they are related to adverse selection and risk retention measures, transparency, addressing re-securitization related issues, reduce excessive reliance on credit rating agencies and there is no need to regulate further:

- Adverse selection and risk retention measures: CRD II (Dir. 2009/111/EC) already introduced provisions to prevent "adverse selection" of assets for securitization, by requiring that the composition of pools of underlying assets

[4] Example of maturity transformation performed by the banking system: it borrows on a short-term basis to fund longer-term loans (loan extended is of longer tenure than the deposit created).
[5] For instance, drivers that could affect the stability of the financial system are the long chain maturity transformation outside banks, and the links between market liquidity and funding liquidity

reflect the average risk portfolio of the bank. CRD II also introduced a retention requirement of 5%, which aligns the incentives along the securitization chain. This approach strikes the right balance between risk-sensitivity and economic incentives for securitization/re-securitisation: CRD III (Dir. 2010/76/EU) updated, from the backdrop of the crisis, the prudential standards applicable to treatment of securitization for the purpose of capital requirements. It also provided incentives to use simple products introducing differentiated treatment for securitization and re-securitisation, and by applying higher risk-weights and multipliers to re-securitisation;
  - Transparency: ABS loan-level initiative by the ECB and MIFID;
  - Reducing reliance on credit rating agencies: Credit rating Agencies Regulation in EU.

EU needs to develop its securitization markets for closing the funding gap that has emerged from the 2008 crisis, and for channelling growth financing to the real economy. It is of relevance particularly to SMEs and midcaps, which usually don't benefit from capital markets, and are heavily dependent on bank loans – they have shorter histories, are often unrated, and usually don't generate economies of scale necessary for sufficient visibility in the financial market. Securitization would help these enterprises access a broader pool of liquidity, particularly in times of credit shortage. In 2010, an excess of €35bn represented SME securitizations, which corresponds to 10% of total securitised assets in the EU. Securitisation is also needed to ensure the continuous provision of long-term credits, whose maintenance on the balance sheets is discouraged by the changes coming into force with CRD IV.

We need to point out that in Europe there is a lack demand for securitized products having maturities exceeding five years. Insurance and pensions funds investors' type have a real interest in investing in products having long maturities, however, they are discouraged by the capital charges penalties imposed by regulations on these products.

We express our support for a sound securitization market. There is need for analysis of which categories of credit should be promoted, by also analyzing the implications for consumption or for investment, by sector. In order for the securitisation market to grow, the interconnection between supply and demand should be restored. The loss of investor's confidence due to uncertain economic environment and the impact of regulatory reforms are the main threats for restoring the EU securitisation market.

In order to recover, securitization market needs to build on regulatory certainty and should focus on simple, transparent products (thus encouraging investors' supply), with high quality underlying and efficient price-discovery. The financial industry provides many examples of good practice to enhance the quality of assets and the functioning of the intermediation. Prime Collateralised Securities (PCS) label [6] is but one of such examples, and the Commission should encourage similar industry initiatives. However, the future of securitization remains in the hands of policy makers and regulators.

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?

One of the French specifities is the existence of several short-term savings products whose strict features are determined by public authorities (e.g. "livret A", "livret de développement durable", "compte epargne logement", etc.). These savings products fall under a tax regime

[6] Private initiative co-sponsored by the EFR and AFME

that privileges liquid and secure short-term investments at a fixed interest rate but at the expense of “more risky investments”, which contribute to the financing of the real economy, such as unit-linked life insurance or mutual funds.

In 2009, EUR 78,9 billion of a total of 100 billion of private savings were invested in life insurance funds and 9,5 billion in tax-exempted savings products. In 2012 these two product categories still accounted for the bulk of private savings but with a significant shift towards non-taxable savings products. These products are also characterized by a relatively high level of earnings compared to medium and long-term products and investments are used primarily for the financing of social housing.

Given the importance of SME financing, we believe, that investments for those savings products need to be driven by a long-term rather than short-term strategy (in relation to the duration of the investments of these companies). Therefore, as the issue of SME financing arises at European level the idea of "some" harmonization of “incentives" towards long-term investments should be considered.

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

The tax treatment is different if a company finances itself by debt or capital. When a firm finances itself by debt, it benefits from a rate of deductible interests. Given the amount such deductible interests represents for companies, we believe that debt financing and capital financing should remain two separate types of investment. Additionally, these two types of investment have different purposes. By borrowing capital, a company invests in businesses whereas a firm invests in services when it borrows debt. We are of the opinion that it would be in the interest of fiscal stability to maintain the distinction between debt and equity financing.

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?

Given their low risk appetite, households have a tendency to prefer liquidity over saving. Indeed, only a minority of households possesses long-term saving. Therefore, it is essential to refrain from taking fiscal measures which would create disincentives for long-term saving.

For instance, the Commission should refrain from taking measures which increase the cost of long-term saving, such as the financial transaction tax. Indeed, as proposed by the European Commission on 14th February 2013, the financial transaction tax would have a negative impact on long-term saving in Europe. By taxing transactions of all types of financial instruments, the proposal would inevitably reduce the return offered on long-term saving, such as retirement products. If savers were to invest in these products, they would eventually bear the additional costs induced by the FTT. In our view, such a tax measure should not be implemented as it will create a strong disincentive for households to invest in long-term financial products.

Additionally, we would like to draw the Commission’s attention on the fact that long-term saving necessarily suffers from fiscal over-regulation, which leads households and investors to adopt a wait-and-see attitude. In our opinion, long-term saving requires fiscal stability. More particularly, tax rates need to remain even. For example, French tax law does not provide households with sufficient stability as regards their share of capital gain. Therefore, French households are not incentivised to invest in long-term financial products.

We believe that long-term saving requires significant fiscal incentives to overcome households' reluctance for saving. For instance, French local investments funds (known as fonds d'investissement de proximité or FIPs in French) are long-term investment funds, which are illiquid and present a risk in capital loss. To balance their illiquidity and capital risk, French authorities grant up to a 40% tax deduction to households who choose to invest in these funds.

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

In our view, deeper fiscal coordination at the EU level would doubtlessly support the financing of long-term investment. The coordination of national tax legislations should promote a stable and harmonised fiscal environment at the EU level. Indeed, the strong discrepancies between national fiscal laws as well as the complexity of each fiscal regime often discourage long-term investment. Obviously, there is a lack of clarity on cross-border investments. Investors are taking risks in investing in another Member State and such risks are only exacerbated if national fiscal treatments change abruptly. By deepening tax coordination at the EU level, the EU would sharply decrease investors' risk to make cross-border investments.

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?

In promoting the fair value, the IASB took for granted that investors and more specifically short term investors are the only users of the IFRS.

As the market value is considered as the "true" value it can only trigger short-termism from management of companies. The fair value model is based on the theory of "efficient markets" which are supposed to react immediately to all information disclosed by companies and which privileges shareholders and short-term investors.

The financial crisis demonstrated the procyclicality of the latter. As during the upwards cycle increasing stock prices triggered an increase in profits and own funds which led to higher stock prices, in the downwards cycle, the phenomenon was opposite and fire sales triggered impairments and reduction in own funds. This is particularly true for banks and insurers.

However, lessons have not been drawn from the crisis. Undue volatility imported from the market into the financial statements and related impact on long-term investing is still a concern which may become even more critical under the forecasted IFRS9 standard, with both a potential instability of the financial position (equity) and the financial performance (profit and loss). The following IFRS9 requirements are examples that illustrate such a heightened concern:

- all equity investments would be accounted for at fair value through profit and loss, regardless of the business model,
- the only option to account for some of these equities at fair value through other comprehensive income (i.e. equity) is overly restrictive, prohibiting the recognition in profit and loss of gains and losses realised on disposal of such investments,
- the fair value through profit and loss becomes the default category, no more ring-fenced to trading activities. Any instrument that would not be eligible to the narrowly

defined amortised cost category would fall into the fair value through profit and loss category, regardless of the related business model[7].

These requirements combined with forthcoming changes in the regulatory framework would result in a double negative effect, potentially a disincentive for banks to provide for long-term financing, in a context where it is critical to support the European employment recovery and to boost the economies:

- a distortion of the performance, failing to reflect the actual business model regarding long term investments. For instance, while the track record of realised gains and losses is a key indicator of the performance of these activities, fair value accounting would not allow their faithful representation in the results. The use of non IFRS measures to reflect such an information is burdensome and discouraging for the business;
- dissuasive capital requirements and prudential ratios.

We consider that the most appropriate measurement attribute to faithfully reflect the performance when the business model is to hold the investments for a long period is the cost measurement with impairment when the intrinsic value (value in use as defined in IAS36[8]) is lower than cost. The uncertainty inherent to the long term investment business model further justify prudence and the use of cost that prohibits the recognition of unrealised gains while taking into account potential losses through impairment. For the sake of enhanced transparency fair value information should be provided but only through disclosures in the notes to the financial statements.

Accounting standards are in the first instance the language of the companies and their management who should be able to use it to translate the economic reality and secondly for other users such as long-term investors who are as important as short-term investors.

Europe should take the opportunity of the decision of the SEC to stop the convergence process between the US GAAP and the IFRS to reopen the reflection on the conceptual approach of the IFRS referential. The fair value model as a model *par défaut* should be questioned. The business model should be included in the conceptual framework together with the notion of prudence that should be reintroduced and the concept of users should be extended to long-term investors.

The general interest for Europe is to stop penalising long-term investing and to ease accounting constraints which are not justified conceptually, and regulatory constraints.

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

It is important to link long-term shareholder engagements with efficient corporate governance. Indeed, shareholders engaged in a long term perspective will be more sensitive to corporate governance issues and to the control mission within the company.

Two important principles that can increase the difficulty of establishing a distinction among shareholders aimed at promoting long-term shareholder engagement: the equality of treatment principle between shareholders and property rights.

Several tools may be used to develop long-term shareholder engagement.

[7] A recent PwC survey (Financial reporting priorities “A European Investor view”, September 2012) found that a majority of respondents favour for a more balanced measurement model including other criteria such as the business model.

[8] *Impairment of assets*

First, the promotion of employee participation seems to be an effective way of developing stable shareholding. The employee's financial participation as shareholders can be promoted by many tools such as tax incentives or employer's participation in exchange for a detention of shares over several years (in France for instance, 5 years). The system can be even more attractive for companies if the shares detained are gathered in a mutual fund by which employees act through a common voice. Mutual funds, which give employees exclusive access to their company but also to other companies, may also be a useful way of channelling employees' savings in a specific direction. The promotion of employee shareholding schemes on a European level is an objective that must be continually worked upon, both from a legal perspective as well as from a tax/social point of view. It is indeed very heavy for groups that put in place operations in several countries to combine the different applicable rules.

Non-financial participation of employees (such as board participation for instance) may also be an efficient way to promote their interest in the company and thereby their will to remain stable shareholders.

Secondly, a common tool is to allow companies to give to stable shareholders a higher dividend and/or a double vote (such a system exists under French law for a two-year detention and is frequently used by companies). If such measures have the effect of encouraging shareholders to keep their shares for a certain period of time, it may also be difficult for shareholders to understand who are new to the company.

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

Asset management companies' remuneration is based upon the assets under management. As a consequence, such remuneration varies according to the type of asset classes, the underlying assets and their performance. Asset managers have in any case a fiduciary duty to maximise returns for their investors. The determination of the investment strategy is fixed in the contract agreed upon between the asset management company and the institutional investor and depends on the financial profile/needs of the investor. If investors want to have access to a certain level of liquidity, a portion of investments will be made in short-term liquid assets (e.g. monetary instruments). If investors are ready to accept a certain level of risk and illiquidity, they might expect higher performance provided they accept a longer duration of the underlying investments.

With regard to the management of funds, UCITS and AIFMD rules provide for numerous risk mitigants (e.g., capped leverage, restricted eligible assets, mandatory diversification ratios, etc.) and excessive risk-taking is consequently not a key issue.

Investors that are clients of asset management companies typically expect their asset managers to use a risk budget (carefully measured and intensively optimized), and draw comfort from the fact that their fund managers are properly incentivized on performance.

Indeed, asset management is essentially a performance/risk-driven industry, which hinges on the quality of service rendered to the client. Performance is of the essence. The EU should not penalize its asset management industry by letting its clients perceive - or its non-EU competitors point out - that it is counter-productively constrained.

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

We do not see a need for regulatory measures at European level in this context. As regards asset managers' fiduciary duties we have already implemented sound governance rules in our company's core values, which are subject to constant review.

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?

Even though quarterly reporting was designed to bring more transparency in corporate' balance sheets, they have proved to be a heavy administrative burden for corporate, which must dedicate a considerable amount of time and financial and human resources to provide markets with such information. Relieving corporate from such cumbersome quarterly reporting obligations would enable them to present their financial results on a longer period of time, which would consist in a better reflection of their economic policy objectives. Nevertheless, markets are unlikely to accept that corporate which are currently used to provide quarterly reporting will return to semi-annual reporting.

Qualitative explanation must accompany quantitative financial results so as to ensure the correct understanding of the markets. But it should be up to the company which discloses the figures to provide markets with the qualitative means to understand these figures. A better understanding of the economic and financial functioning of a company is not about the quantity of the information but the intelligence of those figures.

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

Before considering any new initiatives to set up specific markets and products for SME financing, we need to take a step back and think about creating the right setting.

First, awareness needs to be raised at the level of the SMEs: where are the benefits of looking for alternative sources of finance and of diversifying funding? An advisory framework could be envisaged to help them settle any technical, legal or operational issues. At the same time, economic incentives may be considered to make accessing alternative sources of financing more attractive, given for example the considerable costs of acquiring a prospectus and getting listed and the administrative burden of periodical reporting.

Secondly, investor appetite will be crucial in order to make any SME specific initiative successful. Market transparency, liquidity and standardisation of products could contribute to investor confidence, as well as advisory and analysis so that investors can make well-informed decisions. Banks could play a helpful role here, providing their expertise and assisting both SMEs and investors in matching their interests, which would be complementary to the banks' traditional role of SME lenders.

At the same time awareness should be created as to the investors' contribution towards sustainable economic growth and social responsibility. For example, asset managers could incorporate a certain percentage of SME exposure in their funds: this would add to the performance of the fund and at the same time ensure access to capital for the SMEs.

A successful reactivating of the SME securitisation market depends to a great extent on regulatory requirements and their effects on the market, paying close attention to reducing the effects of systemically relevant thresholds (notably transition of Investment Grade to Non-Investment Grade).

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?

Over the past decade SME securitisation has become an element of the financing of SMEs in Europe with growing significance in some European markets such as Spain, Germany, the UK and Italy. However, the near-collapse of the European structured finance market, in tandem with other markets around the globe, has profoundly affected the status and outlook of SME securitisation.

SME securitisation, as all other securitisations is still suffering from the economic and financial crisis. In the first quarter of 2012, € 7.7 billion of SME securitized products were issued in Europe, a 50.9% decline from Q1 2011. Furthermore, only 19.1% of the total issuance of SME securitised products in Europe in the first quarter of 2012 was placed in the market, with the balance being retained by the issuer.

The structure of SME lending prevents the sale and/or treatment on financial markets in particular because of their modest size. Securitisation arises as a source of refinancing due to the transfer of the risk (from the banks' balance sheet to the financial market) which has important benefits for the companies (opportunity and financing costs) as well as for the credit institutions (facilitated refinancing).

Public sector support also plays a crucial role in reactivating the SME securitisation market. A possible model to look at is represented by the KfW bank, the German government-owned development bank. This government-backed scheme has proven its effectiveness in channeling cheap funds to SMEs during the current economic downturn and represents a model that could be adopted successfully elsewhere. Examples of the approaches pursued include the promotion of the capital markets and the securitisation of SME loans. Through securitisation platforms it has helped commercial banks to transfer loan risks from SME portfolios to the capital markets, thereby giving credit institutions more scope to extend new SME loans. In cooperation with the Commission and the Council of Europe Development Bank (CEB), KfW also provides "Global Loans" to European commercial banks to help them finance SMEs on attractive terms. The public agency, which could be set up by the Banque Publique d'Investissemen for a French program or the European Investment Bank for a project at the European level, would offer many advantages:

- A guarantee for reducing risks for investors (credit enhancement; process already used by the EIB and EIF + OSEO in France)
- A standardization of the form of loans as well as their diversification according to predefined criteria will allow for significant cost reductions both for the structure and the intermediary
- A capacity to act as a technical intermediary (rating system, experience, transition matrix, ...)
- Its presence in the deal would increase the appetite of investors
- Following the allowed refinancing the bank has new cash available for the financing of the economy
- It would provide access to an important public bank
- It would provide assistance to smaller institutions and reduces barriers to entry for securitization

Another successful example of government intervention can be found in the US, where the government has been active in promoting alternative sources of capital, such as leasing, mezzanine finance, micro credit and VC. In the EU, VC and business angel finance currently provides only 2% of SME financing, while in the US the figure reaches 14%.

It is important, however, that public support for SME securitisation must be made conditional on ensuring “additionality” i.e. extending new loans to SMEs so that they profit from the support given to the transaction.

Industry-led initiatives could play a particularly important part in restoring investor confidence. The True Sale International (TSI) and the Association of German Banks (BdB) are currently coordinating the establishment of a German prime market for securitisation.

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?

The public sector is a key actor in providing long-term investment. But in the years ahead, government resources are likely to be constrained. For governments to be able to provide long-term investments in the medium-term, it is imperative that they restore their public finances to good health over the short-term and diminish the share of social spending which are short-term and unproductive in favor of investment spending which are long-term and favorable for the employment.

This needs to be complemented by rigorous national economic policies which fosters Europe’s global competitiveness and attracts foreign savings.

As outlined in the G30 report, the demand for long-term investment is projected to rise substantially as mature economies address long-deferred infrastructure needs. In this regard, export finance plays a crucial role in financing assets in the infrastructure sector on a long term basis. However, we have identified a number of shortcoming in this field:

<u>OECD consensus does not cover the liquidity issue</u>

The OECD consensus governs the terms and conditions of export finance supported by Export Credit Agencies (ECA) of the OECD countries. Unfortunately, the consensus does not cover the liquidity issue, which leads to major differences in terms of volume of available liquidity and pricing among the major exporting countries.
In some countries liquidity is provided by funding vehicles such as the Japan Bank for International Cooperation, Korea Eximbank or by ECAs themselves such as US Ex-Im Bank, Export Development Canada (EDC) or - outside the OECD - by China Exim Bank.
Within the EU, countries can be divided in two categories with those owning a funding vehicle (ECN in Norway, ELO in Denmark, FEC in Finland, SEK in Sweden, KFW in Germany or CDP in Italy) and those relying mainly on commercial bank funding (UK, Netherlands, Belgium, Spain or France).
In addition, within the EU some financial institutions participating to the funding of export benefit from Basel III exemption.
Funding vehicles increase the differences within the OECD consensus on key specific sectors such as renewal energy, nuclear or rail, which can benefit from long tenors.

Although it may take some time to address the divergences mentioned above, we suggest to involve the EIB especially for the longer-term maturities of export finance loans while maintaining the strategic role of commercial banks for the medium-term maturities.

Competitiveness of European export finance vis-à-vis OECD countries and the BRICs

US Ex-Im publishes each year a comprehensive report to the Congress on Export Credit competition which is available on their website. The annual report covers the OECD countries and the BRICS. We suggest to publish a similar report at EU level.

ECB eligibility criteria and CRD/CRR IV

The latest LTRO opened the door to the refinancing of export finance assets in France and Italy. Nevertheless, the ECB criteria made it practically impossible to collateralize the assets. Discussions are currently taking place within the Eurosystem whether a revision of the ECB criteria is necessary. In this regard it would be crucial to reconsider the criterion allowing a borrower to be registered outside the euro area, knowing the ECA guarantee ring-fences the risk within the euro area.
We understand that the ECB is looking at this issue and focuses its assessment on the potential impact in terms of volumes. It should be noted that the volumes available are dependent from those which are already collateralized through the existing covered bond programs ("Pfandbriefe" in Germany). We therefore recommend to include in the assessment the qualitative impact of eligibility for bank treasurers and the added value in terms of pricing provided to euro area export finance.
In the context of CRD/CRR IV, it must be insured that for the LCR the HQLA take into account the definition of ECB eligible assets for repo facility.