International
Capital
Market
Association

ICMA

ASSET MANAGEMENT AND INVESTORS COUNCIL

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

25 June, 2013

Dear Sirs,

Response by the International Capital Market Association (ICMA)
RE: European Commission Green Paper on the Long-Term Financing of the European Economy, 25.3.2013

Introductory comments

The International Capital Market Association (ICMA) represents participants of all types - issuers, institutional investors, and intermediaries - in international fixed income bond markets. ICMA is one of the few European-focused trade associations having both buy-side and sell-side representation. The ICMA Asset Management and Investors Council ('AMIC' or 'the Council') was established in March 2008 to represent the buy-side members of the ICMA membership. AMIC is composed of a wide variety of investors and asset managers, and it is therefore particularly important that the European Commission understands its views. The AMIC's composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. While ICMA's specific area of expertise on the sell side is in the fixed income sector, the AMIC's focus is on a broader set of issues and sectors which are of concern to its membership, rather than having a specific product focus. AMIC's focus is on asset management in Europe, while recognising that asset management is a global business.

In considering the European Commission's consultation, we have found it useful to consider three aspects of long-term financing, which it is important to keep distinct:

1. The need for a thriving corporate bond market as a source of term funding for the productive economy and term investment for fund managers and insurers;
2. The need to sustain the market in very-long-term investment assets (such as infrastructure), which require a correspondingly long term investment horizon;
3. The need to find ways of limiting the impact on term funding and investment markets of opportunistic short-term trading.

On the first aspect, in March 2013 ICMA published a paper on the Economic importance of international corporate bond markets (the "Economic Importance" paper [accessible via http://www.icmagroup.org/]. ICMA's "Economic Importance" paper explained why corporate bond markets are so important for economic growth, for investors, for companies, and for governments, around the world; and why it is therefore essential that laws and regulations that affect them avoid any unintended adverse consequences that could inhibit those markets. We believe that the "Economic Importance" paper has a high level of consistency with the tenor of the European Commission's consultation and the argument and main conclusions set out in the Commission's Green Paper and Staff Working Paper. We strongly agree with the comments on page 3 of the Green Paper about the need for appropriate regulation and regulatory calibration. We agree with sections 8 and 9 of the EC Staff Working Paper that debt capital markets will play an increasingly important role in filling gaps left by bank financing.

In considering all three aspects, it is important to take account of market conditions in the post-financial-crisis era. Companies are generally under-borrowed and long cash, exercising very conservative balance sheet management, in contrast to past periods of high corporate leverage. At the same time, investors are very hesitant to take on credit risk and duration risk when the market consensus expects bond yields to rise.

We believe that the Commission's Green Paper should form the basis for a broad-based and technical discussion of what policy approaches are needed to help finance a sound long-term economic recovery in Europe. The aim should not necessarily be a rigid EU action plan, but a broad and evidence-based understanding of what may need to be done, at national, European, or international level, but also taking account of private sector initiatives and commercial incentives, the power of the market to fulfil investors' and companies' needs, the particular characteristics of different instruments and markets, and the possible need for the public sector to remove obstacles as well as to provide encouragement. An important example of a non-legislative initiative is the Stewardship Codes, based on a 'comply or explain' principle, initiated by the UK Financial Reporting Council, EFAMA, and in some other Member States, under which asset owners and managers have committed to invest in shares with a long-term view, yielding improvements in dialogue between companies and their shareholders.

The Supply of Long-term Finance and Characteristics of Long-term Investment

Q1) Do you agree with the analysis set out regarding the supply and characteristics of long-term financing?

We broadly agree with the analysis in section 2 of the Green Paper, which is consistent with ICMA's "Economic Importance" paper. We stress the importance of facilitating household investment in corporate bonds, either directly or through collective investment, to provide the benefits we identify to both investors and companies. We stress the importance of maintaining the EU's openness to foreign direct investment, in particular ensuring that EU regulation of interactions with third country markets and intermediaries does not constrain either Foreign Direct Investment or third country companies' patronage of EU capital markets.

Policy making needs to take account of the fact that the financial crisis has reduced investors' appetite for illiquid, as well as risky, investments, even at a premium, a shift which has been compounded by regulatory requirements such as stricter liquidity requirements for UCITS funds and insurance companies. While regulation is necessary for financial stability and confidence in markets, in order to support economic recovery and growth it also needs to accommodate informed and judicious risk-taking.

We stress that an upgrade and simplification of the regulatory framework concerning investments in key sectors such as infrastructure is of paramount importance. In the end long-term investing is about making the country or sector in question more attractive to investors.

Q2) Do you have a view on the most appropriate definition of long-term financing?

We discourage the Commission from basing policy on too rigid and monolithic a definition of long-term financing. In our introductory comments we identify three distinct aspects of the issue which need to be considered separately. Furthermore, companies rely on a mix of funding methods depending on their commercial needs. As explained in ICMA's "Economic Importance" paper, the duration of bonds varies according to the economic purposes for which companies raise funds, their financing needs, what the market will bear, and investor demand. Policy needs to be based on a general understanding of long-term investment as the process by which the financial system accommodates term lending and borrowing, and other forms of economic funding and investment over extended periods. It is also important to bear in mind that larger corporates' fixed income financing needs will often be much longer term than SMEs', for example if the funds are needed to finance large infrastructure projects.

It is important to maintain a clear distinction between forms of non-bank alternative financing which correspond to the investor's investment horizon, and unregulated forms of credit arbitrage, leverage, and maturity transformation. EU policy on shadow banking should focus only on the latter.

From the broader buy side perspective of AMIC, long-term investments focus on private equity, real estate and infrastructure, investments which are by their nature illiquid.

<u>The Capacity of Financial Institutions to Channel Long-term Finance</u>

<u>Q</u>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?

We broadly agree with the European Commission's analysis of the problems afflicting long-term financing by banks, and the need to fill the gap left by bank deleveraging since 2008. Europe needs to move towards more liquid, active, well-documented, and well-regulated market-based term funding, of a type similar to the United States' more mature markets. ICMA's "Economic Importance" paper provides a detailed analysis of these issues. It identifies the capacity of corporate bond markets to help fill the gap, at least for more established companies, and the role of corporate bond markets in helping smaller companies to graduate from bank funding to national and international bond markets as they grow and their funding needs evolve, though given the time that will be needed for the corporate bond market to develop, other means will need to be explored to resolve the problem of the lack of risk capital for corporate lending. Properly designed securitisation with a sufficient level of retention could be investigated in that respect.

<u>National and Multilateral Development Banks and Financial Incentives</u>

<u>Q</u>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?

Coinvestment between private sector investors and development banks has great potential to support long-term investment. Investing alongside the EIB or another EU institution would provide important enhancement of the credit quality of a potential investment, by virtue of the high credit rating of national or supranational institutions, as would the provision of guarantees, whether wholly or partially, by development banks.

Q5) Are there other public policy tools and frameworks that can support the financing of long-term investment?

There should be more focus on instruments for the sharing and/or guaranteeing of risk as a way of reducing risk for long-term investors. Tax incentives may also help support long-term investment.

Institutional Investors

Q6) To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

We broadly agree with the European Commission's analysis of the important role of investment funds, including pension funds and insurers, in providing long-term financing, at a time when banks are withdrawing from their traditional role in the financing of long-term investments, but when ageing European populations need to save and invest for retirement. European institutional investors such as pension funds and life assurers have long-term liabilities, which they must match with appropriate long-term assets, for which they therefore provide significant demand. Institutional investors are also the main sector which has a large pool of capital available for long-term investing. A major focus of the Commission's work should be on how to ease this major source of capital for long-term investing.

The Commission's Green Paper does not make significant reference to the scope of the corporate bond market to fill investment funds' needs, as explained in ICMA's "Economic Importance" paper, though this is an important theme of the Commission's Staff Working Paper, which we urge the Commission to emphasise as the policy discussion develops. Corporate bonds, infrastructure loans, and other forms of long-term investment can help institutional investors match the duration of their assets and liabilities as required under Solvency II, in a way that reduces dependence on investment in long-dated sovereign instruments, especially in the current low yield environment. It is important for the regulatory, policy, and taxation regime to enable them to do so.

Q7) 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?

Long term or less liquid investment should not be unduly penalised by prudential regulation. A relaxation of investment restrictions and the inclusion of more risky assets should be contemplated. In particular, a less restrictive view on matching of long-term liabilities should be introduced in regulation such as Solvency II.

It is important to recognise that the continuity and predictability of regulation is an important factor, since even if the current regime is benign, investors may be deterred if they fear that later policy changes may make long-term or illiquid investment unattractive in future.

Q8) What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?

A major consideration for the creation of pooled investment vehicles is whether they will be UCITS-compliant. UCITS-compliance would effect a major change in the infrastructure and SME bond markets, but without UCITS compliance there would be major obstacles.

Tax barriers are an important obstacle to creating vehicles suitable for investors throughout Europe. The lack of harmonisation of European tax regimes means that offering vehicles on a cross-border basis creates tax inefficiencies and structuring complexities.

For institutional investors there are no legal or regulatory barriers to creating pooled investment vehicles for long-term investments. There are ample opportunities under AIFMD to create pooled structures appropriate for their liquidity and maturity.

For individual investors, there is no harmonised framework for offering pooled long-term investments. The development of such a regime within the AIFMD framework would be beneficial.

Initiatives to increase the access of individual investors, for example to the infrastructure loan market by creating bond issues, should be examined with care to ensure that they do not create the risk of artificial liquidity.

Q9) What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?

See Question 6 above. Easier access and more transparent markets would help institutional investors to support long-term finance, though a balance needs to be struck to ensure that the benefits of greater transparency are not outweighed by lower returns.

We highlight the scope for corporate bonds to channel long-term finance, as explained in detail in ICMA's "Economic Importance" paper.

There is also great scope for the development of markets in structured products, securitised or collateralised loan obligations, and collateral bond obligations, collateralised against infrastructure bonds or pools of SME bonds; and in indexed bonds for infrastructure projects.

The Combined Effects of Regulatory Reform on Financial Institutions

Q10) 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?

We agree with the European Commission's analysis of the vital importance of assessing the cumulative impact of current and planned prudential reforms. There is no doubt that the cumulative impact of new regulation is leading to less capital being available for long-term investing, with banks pulling out of cross-border lending, particularly in Europe. From the asset management perspective the emphasis in UCITS and, to a lesser extent, AIFMD on liquidity requirements in prudential regulation appears to work against the ambition to encourage long-term investment, since the illiquidity of long-term investments, combined with the cyclicality of markets, makes them vulnerable to economic downturns.

It is important to note that non-prudential rules can also deter successful funding, and therefore need to be included in the analysis of cumulative impact: see for example the analysis in ICMA's "Economic Importance" paper of the inhibition of retail involvement in corporate bond markets arising from the disclosure and liability regimes in EU prospectus and public offer legislation, and the need for appropriate design of withholding tax regimes to support long-term investment while targeting malpractice and secrecy.

See also our comments under Question 3 above on the importance of distinguishing between long-term investing and shadow banking. Institutional investors are not banks, and the call for regulation of shadow banking risks creating an additional negative impact on long-term investing capital.

<u>Efficiency and Effectiveness of financial markets to offer long-term financing instruments</u>

Q11) How could capital market financing of long-term investment be improved in Europe?

We agree with the European Commission's identification of the need for a better environment in Europe for SME and mid-cap access to markets. It is important to understand however that in fixed income, as in other markets, SME issuance is inherently more risky and less liquid than larger corporates', and that investors may therefore either be less willing to invest, or demand higher returns to compensate for risk or illiquidity. As well as improvements to information, transparency, and investor protection, emphasis needs to be placed on ensuring that regulation does not inappropriately or inadvertently impede investors' and issuers' ability or willingness to access the capital market. The extension of market and transparency regulation from equity to fixed income and other markets under MIFID II needs to be well adapted and well calibrated to reflect the particular characteristics and dynamics of secondary corporate bond markets, which differ markedly from those of equity markets. The development of effective markets will depend on finding the right product structures, an appropriate regulatory framework, the ability of investors to buy and sell easily, and a well diversified pool of assets underlying the issue.

Q12) 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?

These matters are dealt with in detail in ICMA's "Economic Importance" paper. An important consideration with regard to the provision of equity finance to SMEs is to find ways in which they can be provided with long-term finance which do not involve inappropriate dilution of ownership, for example by the development of markets in convertible bonds.

Q13) What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?

ICMA Members foresee both potential benefits and drawbacks of harmonisation of the EU framework for covered bonds. Arguments in favour are that investors could benefit, and be encouraged to a higher level of investment, by a more harmonised EU framework - covering the structure of the product, the quality of the cover pool, dual recourse to the cover pool and issuing bank, and consistency of market valuation - to facilitate comparison between countries and investment decision-making. Arguments against include the potential for harmonised requirements to preclude existing practices in some national markets, and the potential for a harmonised regime to disturb the activity and liquidity of existing diverse national markets.

Q14) 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 treatment of Asset Backed Securities under Solvency II is likely to make them unattractive for investment by insurers, and to lead to divestment from this asset class. Properly used, securitisation is an important risk transition mechanism in the financial sector. To unlock risks at banks, and to accelerate lending to SMEs and individuals, a well-functioning securitisation market is essential. Regulators and market practitioners should work jointly to differentiate securitisations according to the tranching, retention ratio, and pass-through approach that they adopt.

The private placement market is not as well developed in Europe as in the US. However, Basel III pushes European banks towards the US banking model. The transformation will take time, but will involve a more substantial role for institutional investors in the private placement market. Regulation should support this development, for example as regards the treatment of non-rated loans.

Cross-cutting factors enabling long-term saving and financing

Q15) What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?

We agree with the European Commission's caution that state intervention must not distort competition or crowd out private investors. Products for retail investors are likely to need to be either UCITS-compliant, national Alternative Investment Funds with restricted liquidity, or exchange-traded.

Taxation

Q16) What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?

We encourage a considered approach to the issue of tax deductibility of bond interest, bearing in mind the wide adoption of this treatment worldwide, and the policy considerations which originally underlay it.

Q17) 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?

An essential consideration will be whether it is tax-efficient to save; whether the relevant product offers real investment returns; and transparency as regards what is in the fund, the investment philosophy, and a reasonable level of fees. Incentives could apply either to the instrument or to the envelope through which the investor takes long-term positions (pension schemes or life assurance, for example).

Q18) Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities?

It is important to avoid duplication of taxation at the level of both the individual investments constituting the fund, and of the fund as a whole.

Q19) Would deeper tax coordination in the EU support the financing of long-term investment?

We highlight here the need for coordinated and economically rational double taxation policy, as explained in detail in ICMA's "Economic Importance" paper.

Accounting Principles

Q20) 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?

Long term assets are difficult to value, for several reasons, including: (1) the intrinsic unpredictability of returns from long-term enterprise; (2) pockets of liquidity, particularly at and shortly after the issue of bonds, which may result in sharp subsequent declines in prices and liquidity due to changing market conditions; (3) price feeds errors or wide bid/offer prices. We refer the European Commission to AMIC's 4th November 2010 letter to IOSCO on the valuation of illiquid investments: http://www.icmagroup.org/assets/documents/About-ICMA/AMIC/AMIC%20response%20to%20IOSCO%20consultation%20report%20_2_.pdf

We also broadly agree with the conclusions of the UK Kay Report on Making companies more accountable to shareholders and the public.

We do not consider that mark to market valuation is driving short term behaviour by genuine long term investors seeking long term investments. However, alternative valuation methods would be better adapted for long-term investments with lock-in periods or limited liquidity. Furthermore, pressure from regulations, such as requirements to provide quarterly performance numbers, may lead to short term behaviour.

Liquid assets can quickly become illiquid and illiquidity can cause systemic risk. The limitations on eligible collateral can also mean that liquidity risk turns into concentration risk. Inappropriate collateral can mean that the initial investments held can be transformed into a completely different credit risk (e.g. index-linked notes backed by government bond collateral). It is important for institutional investors to know that they can trade in these investments.

It is important not to limit the ability of banks to take on the early risk in long term investments.

Corporate Governance Arrangements (for asset managers)

Q21) What kind of incentives could help promote better long-term shareholder engagement?

We consider that the focus should be on removing or avoiding obstacles to long-term investment, rather than providing specific incentives.

As noted in our introductory comments, we support the UK Financial Reporting Council's Stewardship Code, and efforts to apply its principles internationally.

Q22) How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?

Asset managers already have a strong commercial incentive to provide underlying investors with sustained performance. The focus should be on ensuring that relevant and succinct information is available to enable investors to make informed decisions.

Fee structures can be an important consideration: long-term fee arrangements can help support long-term investment strategies, whereas short-term fees can encourage overtrading and a short-term approach.

Mandates can assist long-term investment and deter short-term behaviour, for example by specifying which asset classes will be invested in, or restrictions on turnover.

Q23) Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?

On this topic, we refer the European Commission to AMIC's paper "Managing Client Expectations", http://www.icmagroup.org/assets/documents/About-ICMA/AMIC/Client%20Expectations%20AMIC%20FINAL.pdf, which suggests general principles for asset managers on: understanding clients' profile; setting appropriate objectives; ensuring transparency; and reviewing investment guidelines.

Asset management is also thoroughly regulated, in accordance with the long-term obligations that asset managers have towards investors. Some long term investments are effectively providing liquidity to retail investors whereby they can buy and sell units at any time, but the asset managers runs an open ended fund which invests in long term illiquid investments. Continuation of high standards of transparency and risk management is therefore of the utmost importance. Asset managers must be transparent with their customers about the risks of investments. The burden of disclosure should be placed on asset managers.

Information and Reporting

Q24) 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?

Institutional investors conduct their own in depth research to assess the long-term performance and prospects of investments.

Q25) Is there a need to develop specific long-term benchmarks?

Benchmarks already exist for some asset classes, including equities and bonds. However, there is a trend away from benchmark investing, and benchmarking is not well adapted to many long-term investment products, for which peer reviews and comparisons may be more relevant. It is also important to consider how far changes in benchmark constituents may encourage short-term behaviour if, for example, the removal of an asset from the benchmark causes divestment from it.

SME Access to Bank and Non-Bank Funding

Q26) What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

As noted in ICMA's "Economic Importance" paper, it will be important to consider how emerging markets in lending which allow direct interaction between issuers and investors can improve access to non-bank funding by SMEs. It is also important to note that SMEs, using the EU definition, are not large enough or well capitalised enough to attract long-term finance directly. Nevertheless, a number of vehicles do exist which give investors access to mid-cap and SME funding, such as mutual funds specialising in investment in or lending to small and mid-caps; and private equity funds. It will be important to gather more information about the extent of these existing methods of SME funding, and how far they satisfy existing demand from SMEs and investors. Furthermore, the question of SME funding needs to be assessed in the context of the current lack of availability and high cost of credit in stressed Eurozone countries. Thus, for a range of reasons, we believe that a further and more in-depth discussion of SME financing would be valuable, perhaps in a separate discussion from the question of long-term investment.

Q27) 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?

See our response to Q26 above.

Q28) Would there be merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitised products specifically designed for SMEs' financing needs?

See our response to Q26 above.

Q29) Would an EU regulatory framework help or hinder the development of this alternative non-bank sources of finance for SMEs? What reforms could help support their continued growth?

It is difficult to assess in the abstract whether an EU regulatory framework would help or hinder the development of non-bank sources of finance. It would depend on the merits or otherwise of the specific measures proposed, and their consistency with existing rules. We stress the importance of further open discussion, including on technical issues, and a range of possible actions by different actors, rather than an immediate EU action plan. Given that the main purpose of both long-term investment and SME funding is to enable issuers to raise funds securely, and investors to use their funds securely to make real returns, and that the function of markets is to intermediate those needs, the Commission should be wary of prescriptions that might make it more difficult to meet those needs, and open to the possibility of removing obstacles and costs that stand in investors' and issuers' way.

Additional points

Q30) 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?

Stability, consistency, and predictability of policy and regulation, in addition to economic stability, is important to provide an environment which encourages investors, particularly those from third countries, to invest in long-term finance for Europe.

Yours faithfully,

Robert Parker
Chairman
ICMA AMIC