European Commission Green Paper

Building a Capital Market Union

[1]

A Capital Markets Union should move the EU closer towards a situation where, for example, SMEs can raise financing as easily as large companies (4)

The initiative of the European Commission is to be praised as it takes the Liikanen report forward and attempts to reduce the excessive importance of the banking sector as a source of financing. It is perfectly described by Commissioner Jonathan Hill in his speech at the European Financial Integration and Stability Conference. It also tackles one of the anomalies of European finance: the excessive role of balance sheets in the financial intermediation process.

In talking about Capital Markets Union, we should not accept that there is a dichotomy between bank-based and more market-based financial systems. The truth is that we need both. Bank-based funding has many strengths, not least the close relationship that some banks have with their clients, including SMEs. But the crisis has clearly demonstrated that there is a risk in having too many eggs in one basket. A more diversified financial system – with a better balance between direct and indirect funding channels – would be more resilient and strengthen the capacity of Europe's economy to handle any future crises.[2]

The editorial of the former Governor of the Banque National Suisse in the Financial Times on April 16, 2015 endorses the approach.

The CMU aims to remedy this fundamental problem: Europe is overwhelmingly reliant on banks to finance its economic growth, and hardly at all on capital markets. This is in sharp contrast to the US where the opposite is

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On October 1, 2003, Georges Ugeux founded Galileo Global Advisors LLC to offer CEOs, Boards of Directors and Governments independent advice on international business development, restructuring, compliance and capital market issues. Prior to founding Galileo, Georges Ugeux joined the New York Stock Exchange in September 1996, as Group Executive Vice President, International & Research.

[2] Jonathan Hill, speech on the Capital Market Union
http://europa.eu/rapid/press-release_SPEECH-15-4861_en.htm

true. There is no conclusive evidence that either mode of financing is superior, but a system relying meaningfully on both modes will certainly be more robust.[3]

It would be a mistake not to understand that this is a fundamental change of the financial structure in Europe, with its challenges, risks and structural reforms. It also will collide with vested interests that are entrenched and will resist transparency and disintermediation. While this paper will address many of the challenges and opportunities, it does not pretend to go beyond indicating the avenues of this considerable work that was initiated by the European Commission.

The Group of High Experts under Governor Erkki Liikanen sent a very powerful signal in the table it published, dated 2010. The Bruegel report chart confirms that structural changes have not happened over the past five years.

Table 2.3.1: **Size of EU, US and Japanese banking sectors (2010)**

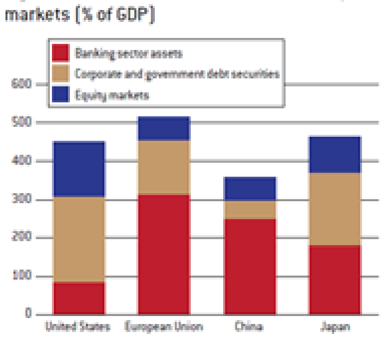
	EU	USA	Japan
Total bank sector assets (€ trillion)	42.9	8.6	7.1
Total bank sector assets/GDP	349%	78%	174%
Top 10 bank assets (€ trillion)	15.0	4.8	3.7
Top 10 bank assets/GDP	122%	44%	91%

Notes: Top 6 banks for Japan.
Source: European Banking Federation (2011).

[4]

Another way to look at this reality has been provided in the Bruegel report to the informal ECOFIN in Riga. It shows the underdevelopment of the European bond market, largely dominated by sovereign issuers rather than companies. The size of the European Bond market is indeed half of the US in GDP terms.

Figure 1: Size of the financial sector and capital markets (% of GDP)



[5]

[3] http://blogs.ft.com/the-exchange/author/philipphildebrand/

[4] Liikanen Report. http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf

[5] Bruegel Report

Applauding the intention should not hide the fact that this statement neither is realistic nor consistent with the practice of developed capital markets. From that diagnostic, the Green Paper is driving the thought process in an array of directions, some of which have little, if anything, to do with a European capital market. It refers to a multiplicity of directives and regulations that are, among themselves, not always coherent and most importantly, are in some cases in contradiction with the stated objective.

In order to be helpful, we have tried to put together several fields that need to be further defined in order to provide a framework.

Main issues to be addressed

The main issues raised by the Green paper are grouped by theme and will be developed in this paper. Each of them is present in the Green paper albeit not addressed in this way.

Liquidity

- Where will liquidity come from?
- The Liquidity Coverage Ratio has a different purpose than capital markets
- The role of the City of London needs to be integrated
- It mixes statistics that include sovereign and corporate bonds
- It does not distinguish between corporate and banking bonds
- Financial intermediation is not the role of investors

Equity and Debt

- The Green paper does not distinguish equity and bonds for private placements
- There is a difference between credit scoring and bond rating

Infrastructure

- Infrastructure finance requires differentiation between debt and equity
- The infrastructure considerations ignore the role of EIB

SMEs

- SMEs and medium size companies need to be distinguished
- The prospectus directive is not directed to SMEs
- Should issuers apply a common accounting like IFRS

- Venture capital funds are not part of capital markets

Regulation

- Regulatory initiatives do not aim at developing markets
- It misrepresents Solvency II as an encouragement to long term financing
- Administrative measures might not be substantial
- It assumes that banks have a problem to extend loans

This comment letter is trying to look at some of the basic realities and misunderstandings on capital markets. We will try not to focus on politically pleasing but ineffective aspects of the Green Paper to answer the basic question: how can the Commission foster capital markets dynamics while the European Banking Union regulation? We will not address the fact that the European Banking Union contains provisions that are discouraging capital market activities by banks.

The diagnostic as to why Europe is behind the curve compared with the USA and the UK has not been made: therefore the Commission's initiative proposes a therapy without spelling the causes. There are some fundamental reasons why this market is less developed in Europe and they need to be identified and addressed. It might be painful, but it needs to be done. *Nobody has asked turkeys to vote for Christmas.*

We understand the difficulty of the exercise and the need for a European Commission initiative. After this Green Paper, it will be essential to organize a thorough consultation of the actors who will –or will not- support this initiative. A Goldman Sachs report on what Global Capital Markets are about might be helpful in this regards.[6]

I see the Capital Markets Union as about growing the overall pie so that everyone benefits: banks, capital markets and, most importantly, firms who will find more sources of funding. Removing obstacles that prevent our high levels of savings from finding their way to productive use in the economy. And it is about giving choice to companies on where and how they want to get financing.[7] echoes Commissioner Jyrki Katainen.

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[6] This educational guide might be helpful to readers who are less versed in capital markets.
http://www.goldmansachs.com/s/interactive-guide-to-capital-markets/index.html?cid=PS_01_82_07_00_00_00_01

[7] ESBG retail banking conference, Brussels, address by Commissioner Jyrki Katainen
http://ec.europa.eu/commission/2014-2019/katainen/announcements/esbg-retail-banking-conference_en

Part I Liquidity

Liquidity is the most important aspect of capital markets.

Primary liquidity is provided by investors, retail or institutional and is by far the most important source of funds. However, investors will not put their money in financial assets that are not liquid enough to guarantee that they will be able to sell their securities in a short period of time without disrupting the price of those assets. It is also affected by important rules and regulations, and in particular Solvency II for insurance companies.

Secondary liquidity is provided by market makers, a combination of banks, broker dealers and securities companies. Unless enough financial resources are allocated to market making by financial intermediaries who themselves are subject to new rules and regulations that affect their market making capabilities.

Philippe Hildebrand asks a pertinent question on the objective of the CMU: *Can liquidity be achieved in Europe without cross-border opportunities? Realistically, not on the scale that it is available in the US. Yet such opportunities are now practically non-existent.*[8]

Action proposal: in order to be credible, the Commission's proposal requires a substantial consultation and understanding of the providers of primary and secondary liquidity.

1. **Where will the liquidity come from?**

[8] http://blogs.ft.com/the-exchange/author/philipphildebrand/

Banks play a key part not only in lending but also in capital market intermediation, notably by providing liquidity through market making.

The Commission is interested in views on how to achieve better priced and robust liquidity conditions, notably whether measures could be taken to support liquidity in vulnerable segments and whether there are barriers to entry for new market participants who can play a role in matching buyers to sellers (24)

The Green Paper addresses liquidity in the context of capital market intermediation by banks and their role as market makers. It is not further developed. The concern is that some market segments indicate a decreased liquidity level. Cross-market analysis of developments in market liquidity is complex. As the Green Paper recognizes, some suggest that liquidity may have been mispriced during the pre-crisis period. Further, liquidity levels may be affected by stricter regulatory requirements for market makers and an overall lack of market confidence. The Green Paper calls for responses on whether liquidity should be promoted in bond and equity markets, and if so, through what measures or mechanisms.

However, to answer these questions, one must determine where in the EU's capital markets the liquidity comes from - or should come from. To address market depth and liquidity, it is necessary to have a clear view of the existing liquidity enhancing market mechanisms and their efficiency. Assessing these mechanisms enables a more targeted debate on whether and how the Commission could promote market depth and liquidity in the course of building the Capital Markets Union. We will address two liquidity-providing mechanisms that can be relevant in this regard.

One mechanism to address the Eurozone's liquidity situation is the **open market operations by the ECB**. It is more of a macro-economic initiative, whose impact on corporate debt is uncertain. Main refinancing operations ("MROs") are one-week liquidity-providing operations in euro with a maturity of normally one week. The aim of MROs is directing short-term interest rates and signaling the Eurozone's monetary policy stance. Longer-term refinancing operations ("LTROs") offer the financial sectors additional longer-term refinancing. To serve the non-financial sector, targeted longer-term refinancing operations ("TLTROs") seek to improve bank lending over a two-year window, excluding house purchase loans to households. TLTROs should prevent a reoccurrence of the 2008 credit squeeze, when banks did not enough liquidity cushion for their illiquid assets and interbank lending and other loan origination seized up. Since 2009, the ECB launched several bond purchase programs, including its recent quantitative easing program (Public Sector Purchase Programme or "PSPP"). In general, the purpose of these open market operations is providing market liquidity by solving short-term cash issues. The European Commission may want to research the economical effectiveness of these individual open market operations by the ECB in relation to its liquidity management.

For equity, **stock exchanges are important sources of liquidity** provided however that the various capital market venues are not fragmented. One of the consequences of MIFID has been to reduce this ability by regulated stock markets. They play a role in allowing the market to efficiently price the liquidity. For example, the German stock exchange Deutsche Börse Group uses its Xetra Liquidity Measure (XLM) to indicate the liquidity for a security in the order book based on implicit transaction costs. In relation to the Green Paper's focus on SMEs, the Eurozone's open markets are worth considering in assessing liquidity management for SMEs. An interesting example is the Open Market ("Freiverkehr") initiative in Frankfurt/Main. The Open Market and its sub-segment "Entry Standard" aim to create liquidity and facilitate SMEs with raising funds at a stock exchange. Compared to a regulated market, the Open Market had fewer access requirements and lower entry costs.

Only the Deutsche Börse Group itself regulates this Frankfurter Open Market. The initiative was not without problems: findings of frequent market manipulation spurred the German regulators and the Deutsche Börse Group to adopt higher transparency requirements. Nevertheless, Deutsche Börse Group warns investors for the risks of less available information on the companies traded in the Open Market. In sum, this German case exemplifies that liquidity available to SME's depends on a crucial trade-off between lower entry requirements and less regulation versus the risk of fraud and subsequent decline of market confidence. As the European Commission itself notices, another alternative for SME funding through bank loans is peer-to-peer-lending (or crowd-lending). If the pool is successfully safe and large enough, peer-to-peer-lending may allow individual lenders to monetize liquidity in a way that banks used to do with regular loans. This on itself could stimulate SMEs funding in alternative to bank loans without having to overcome the difficult – if not impossible task – to enable fundraising for small companies' on capital markets.

This leaves the debt market alone: there is **no existing forum to trade SME bonds**: it is by definition an over-the counter market and

Action proposal: the issue of market liquidity in the Capital Markets Union requires an assessment of the current liquidity-providing mechanisms in their effectiveness and efficiency. In addition to standardization, the Commission may consider the roles of the ECB, of stock exchanges and alternative funding methods (such as peer-to-peer-lending) in promoting market depth and liquidity

2. The Liquidity Coverage Ratio has a different purpose than capital markets

With the … Liquidity Coverage Ratio […] should increase the transparency, consistency and availability of key information, particularly in the area of SME loans, and promote the growth of secondary markets to facilitate both issuance and investments. (10/11)

This is not correct. The LCR is part of the three ratios developed by the Basle Committee of the Bank for International Settlements. Its direct result is to discourage taking long term assets and risks and is an impediment to a capital market. The Basel Committee is very honest about it and is the author of this ratio. It contradicts the comments of the Commission.

This metric aims to ensure that a bank maintains an adequate level of unencumbered, high quality assets that can be converted into cash to meet its liquidity needs for a 30-day time horizon under an acute liquidity stress scenario specified by supervisors.[9]

There is a contradiction in the Green Paper on this subject: by developing a LCR, banking regulation is effectively reducing the ability of banks to provide liquidity to medium- and long-term securities. It is one of the collision courses between regulation and the CMU.

The Committee remains firmly of the view that the LCR is an essential component of the set of reforms introduced by Basel III and, when implemented, will help deliver a more robust and resilient banking system. However, the Committee has also been mindful of the implications of the standard for financial markets, credit extension and economic growth, and of introducing the LCR at a time of ongoing strains in some banking systems. It has therefore decided to provide for a phased introduction of the LCR, in a manner similar to that of theBasel III capital adequacy requirements.[10]

Action: taking into consideration the Liquidity Coverage Ratio, how should market making activities be treated so as not to penalize this essential activity to the CMU.

[9] http://www.bis.org/publ/bcbs238.pdf

[10] op.cit.

3. **The role of the City of London needs to be seriously considered**

The CMU provides a unique opportunity to reconcile the City of London with the European Union. It also requires the French and German Governments to restrain their more or less obvious attempts to undermine the City of London. Furthermore, this effort might make the membership of the United Kingdom in the European Union more meaningful.

In the EU in particular, wholesale financial activity is already highly concentrated in London, and if anything, the recent years of crisis appear to have accelerated the concentration because banks have been forced to restructure their less-efficient activities.[11]

The Green Paper is focused on the continental countries of the EU. London could be brought in this project: European banks have invested in financial resources, information technology and talents in the City of London. They will not replicate that investment in Europe in other cities who, each for their own reasons, have some strengths and weaknesses.

The movement of some financial institutions to Switzerland is a perfect demonstration of the self-inflicted loss of competitiveness of the European Union that benefits other European countries. An interesting study by PWC on the future of capital markets at the 2025 horizon provides important data and comments on what lies ahead. [12]

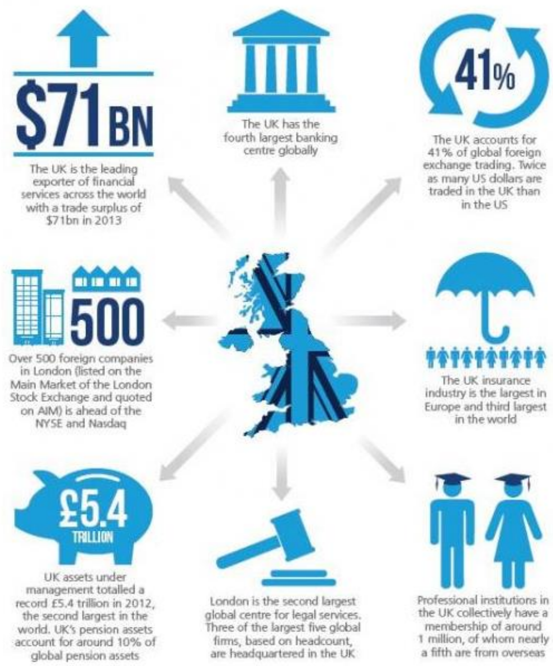
[11] http://www.bruegel.org/publications/publication-detail/publication/878-capital-markets-union-a-vision-for-the-long-term/

[12] https://www.pwc.com/en_US/us/transaction-services/publications/assets/capital-markets-2025.pdf

Key Facts about the UK as an International Financial Centre

Published 03/07/2014

The UK is a major global hub for international wholesale finance. Its financial services trade surplus is more than double that of the next largest surpluses recorded by Luxembourg and Switzerland. Despite concerns about the future competitiveness of London as a global financial centre, it continues to rank strongly in survey evidence and market activity.

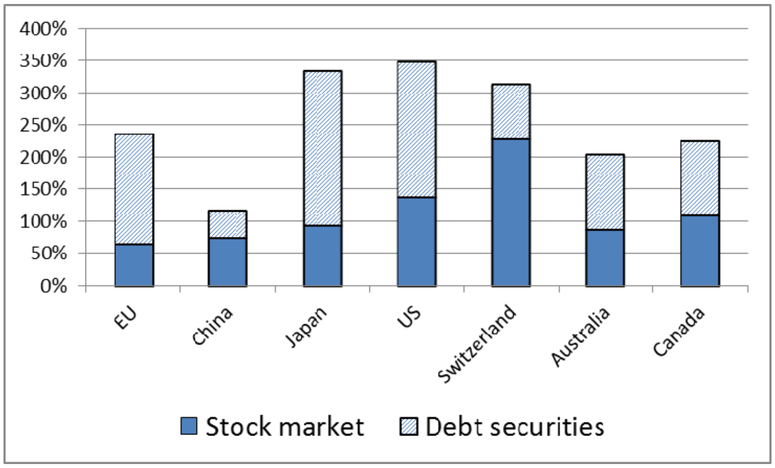


This (self promoting) image of the role of the City of London can be argued about, but not denied. Weakening London would weaken the CMU.

Action proposal: open a candid and constructive dialogue on the role of the City of London in the CMU

4. **It mixes statistics that include sovereign and corporate bonds**

Capital markets have expanded in the EU over recent decades. Total EU stock market capitalisation, for example, amounted to €8.4 trillion (around 65% of GDP) by end 2013, compared to €1.3 trillion in 1992 (22% of GDP). The total value of outstanding debt securities exceeded €22.3 trillion (171% of GDP) in 2013, compared to €4.7 trillion) (74% of GDP) in 1992. (7)



The above chart has been used to substantiate the comment above. However, it fails to look at the central issue. Most of the 22.3 trillion of debt securities is Government debts. It is not a privilege that so much indebtedness by most EU governments exceeds the 60% limit and that Europe is dealing with excessive sovereign indebtedness.

Ten per cent of the outstanding debt securities are in the balance sheet of European Banks representing 100% of their equity. It is the core of the nexus between banks and governments.

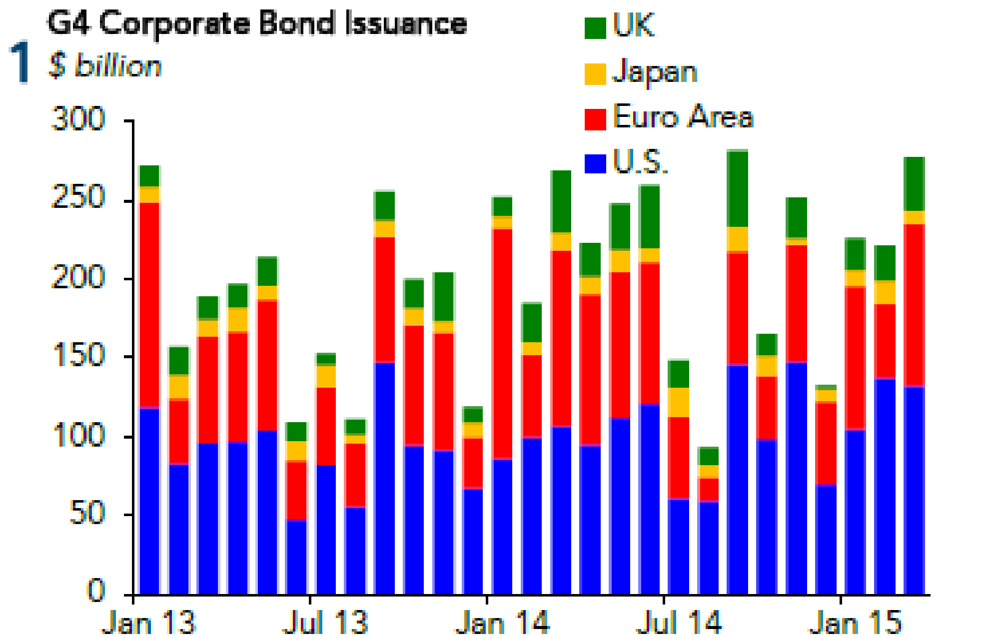
Action proposal: provide research and data on European corporate bonds.

5. It does not distinguish between corporate and banking bonds

However, since the crisis, activity has remained impaired, despite low loss rates in European securitisations. Securitisation issuance in Europe in 2014 amounted to some €216 billion, compared to €594 billion in 2007. (10)

Those numbers look impressive. However, they deserve to be looked at more closely. It shows that Europe is issuing more bonds than equity. What it does not show is how much of the debt issues is done by corporate issuers and by banks. The fact that banks are issuing bonds will certainly meet the investors' appetite for fixed income.

What it does not do, is disintermediate, since the bonds are going to be transformed in assets through the balance sheet of the banks. It would be important to have a clearer view of this split. The charts hereunder confirm that only 1 trillion (out of 23 outstanding) is in corporate bonds. This market includes utilities and telecommunication companies, who are very large companies.



G4 corporate bond issuance, which slowed in the second half of 2014 picked up in the first quarter of the year.

We managed to find some date from the ECB that indicates that of the outstanding securities in the European Union € 16.6 trillion, 1 trillion only is issued by the non-financial corporate sector against 8 trillion issued by financial institutions, who use capital markets to fund their intermediation.

4.2 Securities other than shares issued by euro area residents, by sector of the issuer and instrument type
(EUR billions ; transactions during the month and end-of-period outstanding amounts; nominal values)

1. Outstanding amounts and gross issues

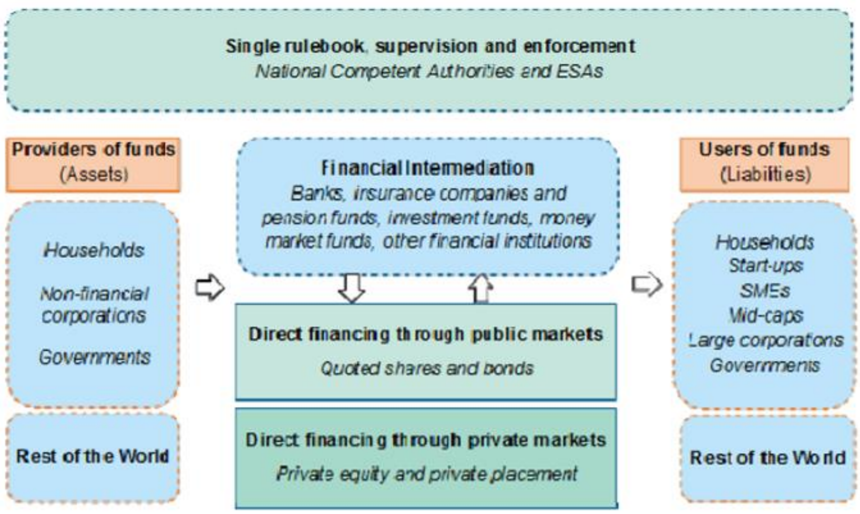
	Outstanding amounts						Gross issues [1]					
	Total	MFIs (including Eurosystem)	Non-MFI corporations		General government		Total	MFIs (including Eurosystem)	Non-MFI corporations		General government	
			Financial corporations other than MFIs	Non-financial corporations	Central government	Other general government			Financial corporations other than MFIs	Non-financial corporations	Central government	Other general government
	1	2	3	4	5	6	7	8	9	10	11	12
	Total											
2013	16,392	4,883	3,245	987	6,598	680	730	385	68	60	188	29
2014	16,435	4,528	3,335	1,055	6,824	693	620	276	76	54	179	35
2014 Q1	16,503	4,816	3,250	1,010	6,740	687	756	372	77	64	202	41
Q2	16,597	4,734	3,284	1,025	6,867	687	712	325	93	64	195	35
Q3	16,532	4,668	3,291	1,050	6,823	700	520	212	68	44	165	31
Q4	16,435	4,528	3,335	1,055	6,824	693	493	193	68	44	153	34
2014 Nov.	16,495	4,548	3,328	1,054	6,871	694	489	186	74	42	160	26
Dec.	16,435	4,528	3,335	1,055	6,824	693	450	210	61	40	96	44
2015 Jan.	16,600	4,586	3,388	1,072	6,859	696	624	247	78	43	207	50
Feb.	16,648	4,573	3,400	1,087	6,888	701	538	210	57	48	167	56

Action proposal: it is indispensible to analyze the current European capital market with more details by country and by industry, and analyze why the European corporate bond market is so underdeveloped.

6. **Financial Intermediation is not the role of Investors**

This Chart comes from the Green Paper. It amplifies the confusion of the liquidity debate. Considering insurance companies, pension funds investment funds and money market funds as financial intermediaries is not correct. They are among the providers of funds (left column) and it is not part of their statutes to be financial intermediaries. This is misleading.

Chart 1. Stylised view of capital markets in the broader financial system



It goes back to the distinction that was made earlier between primary (providers of funds) and secondary (market makers) providers of liquidity.

Action: research the resources allocated by the financial intermediaries to their capital market operations in Europe for European companies.

Part II. Equity and Bonds

The Green paper would have been more understandable if it had completely separated equity from bonds. The providers of funds, the users of funds and the financial intermediaries are different, and more importantly, even if a bank makes market in bonds and equity, those two activities are distinct and respond to different risk profiles, liquidity and capital commitment.

Bonds are left to themselves: there is no such thing as an exchange for bonds. Banks prefer to trade bonds in their trading rooms and over-the-counter. There is no regulation of this market, no commitment of resources and when a crisis emerges, it is the first market that shows sign of weakening, lower liquidity and eventually credit crisis.

The distinction will be treated in this paper in some of its aspects, but this is an area where the Green paper is confusing.

7. Distinguishing equity and bonds for private placements

One way for firms to raise funds is via private placements, where a company makes an offering of securities to an individual or small group of investors not on public markets. These can provide a more cost effective way for firms to raise funds, and broaden the availability of finance for medium to large companies and potentially infrastructure projects. (11)

The notion of private placements only concerns bonds. By definition, while they do disintermediate the banks, private placements do not feed the capital market: they are not listed and are circulated among a handful of buyers. There is no secondary market and no liquidity.

When it comes to equities, there is no shortage of buyers or sellers of shares of private companies. Depending on the level of development of the company, it is angel money (startups), venture capital (small enterprises) and private equity (medium and small companies.

The statement that private placements are cost effective needs to be questioned. Since they are not liquid instruments, the conditions of the issuance are affected by what is known as an illiquidity discount.

Rather than getting more deeply into this issue, it might be preferable to refer to the ICMA task force that tries to improve this market.[13]

As a first step towards developing European private placement markets, a consortium of industry bodies have established a market guide on common market practices, principles and standardised documentation for private placements, compatible with a diversity of legal frameworks. The guide was recently published and the first issuances should follow soon (11)

That makes sense, but does not apply here. It is not part of the CMU.

Action: abandon this subject that is not to be analyzed in the context of capital market

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[13] http://www.icmagroup.org/resources/capital-markets-union/

8. Differentiating credit scoring from bond rating

Work on credit scoring has started and received broad support from Member States. Credit scoring provides investors and lenders with information on the creditworthiness of SMEs. (10)

Credit scoring and bond rating are different by nature and therefore pursue distinctive objectives. A bank does credit scoring (or credit rating) when it lends to individuals or business to assess the risk of the lending. In other words, *"a credit rating is a current opinion and measure of the risk of an obligor with respect to a specific financial obligation based on all available information."*[14] It often benefits from confidential information from a centralized pool of credit information available only to banks and provided by central banks.

The credit rating is assigned to an entity and not to an instrument. This activity is based on qualitative and quantitative information that doesn't necessarily is public and can even be confidential. Likewise, the methodology for rating varies because of endogenous factors of the rated institution. Besides, an SME that has just been created may have difficulties on having immediately an adequate credit score. Credit scoring is therefore not the way to go for SMEs.

On the other hand, **bond rating** refers to a grade given to specific debt securities to indicate their credit quality, based among other information on the credit rating of the issuer.

Furthermore, the confidence on credit rating agencies either for credit or bond rating shown by the Commission in the Green Paper may be contradictory. The Commission has already explained that they plan to reduce the reliance on credit rating agencies ratings[15] by the establishment of the *FSB Principles on Reducing Reliance on CRA ratings*, which are visualized as a multi layer approach that will eventually be adopted by market participants.

Action: to promote bond financing to SMEs the Commission may wish to further develop, perhaps together with rating agencies, an specific SME rating system and focus on giving investors access mainly to the rating of the bond and not necessarily to the rating of the issuer to avoid complications for newly created SMEs.

[14] Role of Credit Rating Agencies. ESME's report to the European Commission. Available at: http://ec.europa.eu/finance/securities/docs/agencies/report_040608_en.pdf

[15] http://ec.europa.eu/finance/rating-agencies/docs/140512-fsb-eu-response_en.pdf and FSB Principles on Reducing Reliance on CRA ratings: http://www.financialstabilityboard.org/publications/r_101027.pdf

Part III Infrastructure

There seems to be confusion on the role of capital markets in infrastructure finance. Infrastructure projects are financed is not part of the development of capital markets. It only affects it through the indirect financing of lenders. The European Union benefits from the ability of the European Investment Bank to provide funding for infrastructure projects.

Action: deal with infrastructure finance outside of the CMU.

9. Infrastructure finance requires differentiation between debt and equity

Finally, the EU requires a significant amount of new infrastructure investment to maintain its competitiveness. The flow of funds to such projects is, however, restricted by short-termism, regulatory barriers and other factors. Also, many infrastructure projects display characteristics of public goods, implying that private financing alone may not be appropriate to deliver the optimal level of investment. While the EFSI will make an important contribution to boosting investment in infrastructure projects, the Commission welcomes views on other means of achieving this goal. (14)

The importance of infrastructure financing cannot be underestimated. It is also a source of employment and economic activity. However, the funds for those projects are of two nature, which is not being distinguished. The Green Paper fails to make an adequate distinction between debt and equity in its discussion of infrastructure finance. This distinction is essential if the Commission is going to adequately address infrastructure financing.

Through the creation of **Special Purpose Vehicles,** promotors and beneficiaries of infrastructure are the providers of equity that is never publicly placed.

Financing major infrastructure projects usually entails both debt and equity financing. Many infrastructure projects are today funded through project finance. In project finance, corporate sponsors provide much of the equity financing. However, infrastructure projects are often not done within the legal entity of the corporate sponsor. Rather, a Special Purpose Vehicle is created. The sole purpose of the Special Purpose Vehicle is to carry out the project. This enables the corporate sponsors to shield themselves of many of the liabilities that could arise if the project fails. In project finance, the only assets that a lender can seize are those belonging to the Special Purpose Vehicle. In this context, there is a strong incentive for equity stakeholders to increase the debt to equity ratio. They have little to lose and a lot to gain by creating highly leveraged Special Purpose Vehicles.

Involving capital in infrastructure finance is extremely problematic. Due to the Special Purpose Vehicles that are at the heart of most project finance arrangements, governments and shareholders can put their liabilities off-balance-sheet. This means that governments and shareholders can increase their liabilities while not also reducing their ability to borrow money. The problem is that governments and shareholders still have the liabilities. Thus, infrastructure financing can disguise massive liabilities. Government guarantees also enable a Special Purpose Vehicle to build up more debt than it might under normal circumstances as projects with government backing appear to be more credible borrowers.

Due to the fact that the only collateral in infrastructure finance is in the Special Purpose Vehicle, infrastructure is extremely risky. Lenders depend on the success of a long-term project to get paid back. These conditions should have great effects on how the Commission regulates debt and equity in infrastructure finance. For this reason, neither the equity nor the debt of Special Purpose Vehicles is listed or public.

The Commission should reject calls to allow projects to be funded with more debt. Taking on more debt would enable more projects to be undertaken. This would provide a short-term stimulus to the European economy. However, the stimulus would be ephemeral as an economic downturn could have an extremely deleterious effect on infrastructure finance. It could negatively affect government finances in particular. Liabilities that are hidden during periods of economic stability would burst forward when the economy suffers a downturn. Government action to ensure that the debt to equity ratio remains manageable must be taken because natural incentives do not encourage fiscally prudent conduct in infrastructure finance.

Private financing may not be enough to deliver the optimal level of investment. However, government support will not improve the situation. It could make it worse. The Commission should find ways to encourage sound equity financing. It should also encourage transparency in infrastructure finance. If the Commission and Member State governments do ultimately decide to become more involved in infrastructure finance, they should establish ring-fenced funds that would enable governments to support infrastructure projects that encounter financial difficulties. [16]

Action proposal: analyze the needs of funding of infrastructure outside of the scope of the CMU

10. Infrastructure considerations ignore the powerful role of the European Investment Bank

Finally, the EU requires a significant amount of new infrastructure investment to maintain its competitiveness. The flow of funds to such projects is, however, restricted by short-termism, regulatory barriers and other factors. Also, many infrastructure projects display characteristics of public goods, implying that private financing alone may not be appropriate to deliver the optimal level of investment. While the EFSI will make an important contribution to boosting investment in infrastructure projects, the Commission welcomes views on other means of achieving this goal. (14)

There is something fascinating to focus on a new initiative that is developed by the European Investment Bank without mentioning it and discussing infrastructure finance without recognizing the importance of the EIB and the EIF in this field.

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[16] World Bank—Public-Private Partnership In Infrastructure Finance, "Government Risk Management," *available* at http://ppp.worldbank.org/public-private-partnership/financing/government-risk-management.

World Bank—Public-Private Partnership in Infrastructure Finance, "Project Finance-Key Concepts," *available* at http://ppp.worldbank.org/public-private-partnership/financing/project-finance-concepts#structure.

David Gardner and James Wright, "Project Finance," *available* at https://www.hsbcnet.com/gbm/attachments/products-services/financing/project-finance.pdf**.**

The EFSI is the European Fund for Strategic Initiatives and is described by the EIB as follows.

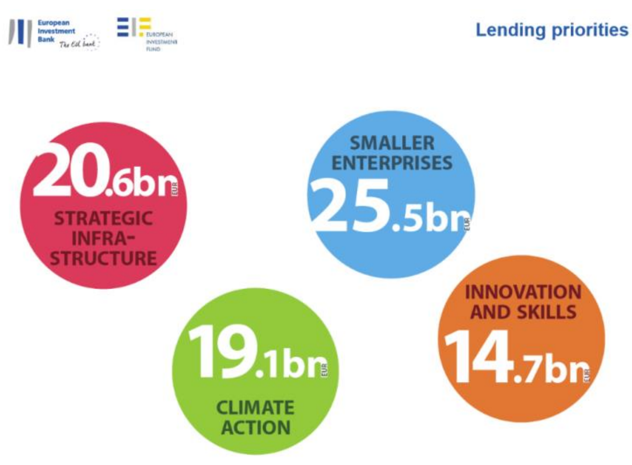
EFSI will take funding to sound projects where needed and where it adds value, increasing risk profile where necessary. EFSI will focus its financing on sectors of key importance where the EIB Group has proven expertise and capacity to deliver a positive impact on the European economy, including:

- ***Strategic infrastructure*** *including digital, transport and energy in particular energy interconnections and urban development*
- ***Education, research and innovation***
- ***Environmentally sustainable*** *projects, expansion of renewable energy and resource efficiency*
- ***Smaller businesses***[17]

In a paradoxical way, it confirms that infrastructure finance cannot be done through capital markets. This "Fund" will not be funded by public markets.

The infrastructure considerations of the Green Paper seem to ignore the role of the EIB group in infrastructure finance. The EIB group is composed by the European Investment Bank and by the European Investment Fund, which is more focused on providing SME risk finance.

The EIB group defines itself as the only bank owned by and representing the interests of the 28 European Union Member States and the largest multilateral borrower and lender by volume. It aims at financing projects in strategic infrastructures, in renewable energies, environmental and urban development, in education and finally helping SME's financing.



As EIB remains to all EU sovereigns, it can enjoy the lowest rates and provides the best quality of sovereign class products. EIB issues euro benchmark bonds under its Euro Area Reference Notes (EARNs) program. There are great

[17] http://www.eib.org/about/invest-eu/index.htm

ranges of liquidity and maturity for those products, which have outperformed AAA-rated sovereign bonds. Thus, BEI group is already really proactive with probably an unbeatable access to low cost funds.

The Green paper suggests a restriction of funds for infrastructure projects because of “short-termism, regulatory barriers and other factors «while EIB place itself in a long-term outlook. Moreover, it makes a point of insisting on SMEs and infrastructure projects, which are the two focuses of the EIB. In its recommendation, the European Commission seems to ignore this existing structure and it is difficult to imagine what could be more efficient. The independency and the exceptional access to funds of EIB might be the best way we have to fund economic growth. Encourage it more than compete it

Action: integrate the EIB in the infrastructure financing and as a powerful element of the EU capital market access.

Part IV Small and Medium Enterprises

It is time for the European Commission to distinguish the small companies and start-ups from the medium-size companies. The example of Germany and the importance of its *Middlestand* has been the core of job creation, competitiveness and technology. [18]

SMEs cannot deal with capital markets.

Most SMEs will remain reliant on banks for their external funding and will not be directly impacted by CMU.[19] Says the Bruegel report on CMU.

It is fascinating to see that the document does not acknowledge the numerous initiatives that have been taken over the past twenty years by capital markets, and even by the European Union. When I was the President of the European Investment Fund, we ere striving with the creation of added value for SMEs. [20]

Small companies need to be dealt with locally, not at European level. Europe has to define a policy to support the Medium-size companies. Capital markets cannot accommodate companies who borrow less than 100 million euro at a time. That, in turn, puts the size of the companies between 1 and 10 billion euros of revenues.

They are the core of growth in Europe.

Action: start a specific action and policy plan aiming to foster the growth of medium-sized companies**.**

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[18] A study of the European Investment Fund on the SME sector in Europe will enlighten the reader.
http://www.eif.org/news_centre/research/investment_and_investment_finance_in_europe_2015_en.pdf

[19] http://www.bruegel.org/publications/publication-detail/publication/878-capital-markets-union-a-vision-for-the-long-term/

[20] By taking SME risk, the EIF pursues two main statutory objectives:

- Fostering EU objectives, notably in the field of entrepreneurship, growth, innovation, research and development, employment and regional development;
- Generating an appropriate return for our shareholders, through a commercial pricing policy and a balance of fee and risk based income.

www.eif.org

11. SMEs and Medium size companies need to be distinguished

SMEs can raise financing as easily as large companies; costs of investing and access to investment products converge across the EU; obtaining finance through capital markets is increasingly straightforward; and seeking funding in another Member State is not impeded by unnecessary legal or supervisory barriers. (4)

Improving access to financing for all businesses across Europe (in particular SMEs) and investment projects such as infrastructure; (9)

Improving credit information would help build an efficient and sustainable capital market for SMEs. (10)

One could agree with these statements if it applied only to medium-sized companies. SMEs do not operate in infrastructure, it is absolutely not straightforward to obtain financing to the markets for them.

On top of those considerations, it does represent a divergence from the principle of subsidiarity. The problem of financing small companies is national, if not regional or local. It would be essential to consider a policy that looks at the Medium sized enterprises who, like the middle class are squeezed and ignored between the big and the small. They are, however, the core of growth because they are significant and meaningful. Their size is sufficient to allow capital market financing, while the small enterprises can only benefit from the markets indirectly, i.e. through financial intermediaries such as banks and venture capitalists.

The Commission cannot be blamed for this amalgamation: if one tries to google “medium enterprises” all the links are for SME as if they were glued together. Medium enterprises can issue bonds or equity in sufficient size to have the minimum liquidity required to ensure the feasibility of a capital market financing.

Action proposal: restrict the CMU to medium-sized companies and provide a definition of those companies.

12. The Prospectus Directive is not aiming at SME

The Commission will review the current prospectus regime through a specific public consultation launched in parallel to this Green Paper, with a view to making it easier for companies (including SMEs) to raise capital throughout the EU4 and to boost the take-up of SME Growth Markets. The review will look at when a prospectus is required, streamlining the approval process, and simplifying the information included in prospectuses. (10)

Since the introduction of Prospectus Directive in 2005, the access of SMEs to public equity fell due to the cost of producing a long and complex document subject to the approval of national competent authorities.

The current prospectus regime will likely not be very useful for SMEs, because SME do not resort to the prospectuses on a regular basis and the investors will anyway operate their assessment on their independent assessment.

An SME prospectus must provide meaningful information to help investors to make an investment decision. A less complex prospectus would mean that companies would produce clearer documents, which are more relevant to both private and institutional investors. It would also reduce the cost and time required to produce them. (Quoted Companies Alliance, February 2015 - Proposals to amend the Prospectus Directive, p. 4).

The Commission must create a separate and simplified disclosure regime for SMEs (Quoted Companies Alliance, February 2015 - Proposals to amend the Prospectus Directive, p. 10). It should apply only to medium-sized companies who raise capital publicly.

This simplified prospectus regime should include the following pillars:

1) *Exemption from vetting by a national competent authority;*
2) *The limitation to a closed set of mandatory disclosures;*
3) *The possibility to incorporate information by reference to what already available to the public*[21]."

13. Should issuers apply a common accounting like IFRS?

The development of a simplified, common, and high quality accounting standard tailored to the companies listed on certain trading venues could be a step forward in terms of transparency and comparability, and if applied proportionally, could help those companies seeking cross-border investors to be more attractive to them. (14)

Users of IFRS would probably have a problem to consider IFRS as simple. Furthermore, oppositions from some countries make its application disparate and explains why the United States have a problem with the lack of statutory rights of the European accounting bodies who can accept exception under political (European or national) pressure. Kara Stein, an SEC commissioner, has described it as an "aspirational goal". [22]

One example of the difficulties it creates is the reaction of the insurance world. It comes from the Association of Corporate Counsel on April 5, 2015.

On 10 March 2015, Insurance Europe published a joint letter from it and the European Insurance CFO Forum to the European Financial Reporting Advisory Group (EFRAG)[23]. The letter highlights concerns over the differing likely implementation timelines for (a) the International Financial Reporting Standards (IFRS) 9 for financial instruments and (b) IFRS 4 Phase II for insurance contracts. The letter states that IFRS 4 Phase II will not be ready by the implementation date for IFRS 9 in January 2018. The letter comments that, where insurers are required to use IFRS 9 before IFRS 4 Phase II is implemented, this will cause confusion and greater costs for insurers. The letter recommends that a solution is found to align the relevant implementation dates.

THE EC is on collision course with European policymakers over its obligation to launch a full review into the legality of international accounting rules and how the body responsible for setting them is run. It seems to assume that SMEs should apply a common accounting like IFRS

The European Union has not adopted the current IFRS for SME's because it was assessed to be incompatible with the EU Accounting Directives; however, the EU has made an allowance that member states can adopt it if they modify it to comply with the recent Accounting and Transparency Directive the EU has implemented.

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[21] Companies Alliance, February 2015 - Proposals to amend the Prospectus Directive, p. 10 – 12

[22] http://www.reuters.com/article/2015/03/26/sec-accounting-stein-idUSL2N0WS1LJ20150326

[23] http://www.efrag.org/Front/Home.aspx

The above Directive is aimed at reducing the administrative burden for SMEs by simplifying the preparation of financial statements and reducing the financial information SMEs are required to report. The Directive will apply to all EU member states.

The fact the IFRS for SME's has not been implemented across the EU suggests that applying a common accounting standard for SMEs across the EU is unrealistic and a better goal would be to simplify reporting in baby steps as initiated by the Directive noted above. In any event, it should be the subject of a separate inquiry not added to an already crowded Green Paper

Action: take IFRS out of the CMU project. It is a different exercise altogether.

14. Venture Capital funds are not part of capital markets

[…] private equity and venture capital play an important role in the European economy. But risk-capital markets can often lack scale; this is the case not only for the stock exchanges specialised in financing high-growth companies, but also for risk-capital investment at the start-up or development stage of new enterprises or in high-technology companies. (17)

Neither private equity nor venture capital is accessing public capital markets. As such, they are not a factor in the CMU project. The source of risk capital for SMEs is definitely complex, and funds have become a key resource for them. However, even in the United States, those funds are not listed and do not raise capital through public markets.

Stock Exchanges do not list venture capital and private equity firms because they do not want to be listed. The nature of their private investments makes valuation very difficult. They are to be put in the category of private placements.

Action: leave private equity and venture capital out of the scope of the CMU.

Part V. Regulation

There is something perplexing in seeing the reemergence of regulatory initiatives that were aiming at the financial stability and resolution of crisis reemerge in the context of capital markets. While obviously everything is in everything and vice-versa, the CMU will be driven by some of the considerations that have been indicated above.

The European regulatory framework tries to protect taxpayers from having to bail out financial institutions. It does not aim at developing new markets, let alone incites banks and insurance companies to become critical players in this initiative.

The ever-obsessive regulatory mind of the Commission lacks a fundamental business vision and a clear policy. Using regulation will not enhance the effort.

15. The Green Paper spends a considerable amount of time on administrative measures that are not critical

The development of a common minimum set of comparable information for credit reporting and assessment could help to attract funding to SMEs. In addition, standardized credit quality information could help the development of financial instruments to refinance SME loans, such as SME securitisation. (10)

However, securitisation is just a method for banks to transfer the risk for their loans. It is true that securitisation helps banks to reduce their risk for their loans, but this does not guarantee that banks will increase the amount of loans to SMEs.

If banks could increase their loans to SMEs due to the promotion of securitisation, this means that banks ease their loan terms expecting the future securitisation. However, this ease of loan terms is unlikely to occur especially in SME loans, where sophisticated assessments of financial condition and profitability are required and it is difficult to ease the loan terms solely by expecting the future securitisation.

Moreover, if the ease of loan terms could happen, this would lead to moral hazard of banks. That is to say, they could actively finance SMEs expecting to transfer their risk for the loans to other investors. To address this issue, currently, “a common minimum set of comparable information for credit reporting and assessment” is under development, but this measure does not seem to work in SME loans. This is because, in SME loans, sophisticated assessments of financial condition or profitability are required and it is difficult to provide “comparable” information for these loans.

16. Regulatory initiatives do not aim at developing markets

Long-Term Investment Funds (ELTIFs) regulatory framework will allow investors to put money into companies and infrastructure projects for the long term. ELTIFs should have particular appeal to investors such as insurance companies or pension funds which need steady income streams or long term capital growth. (11)

How can long term investment funds become an instrument that will activate capital markets? The placement of funds is not made on the public market but offered to private investors. Infrastructure funds are often a name that covers UCITS funds that invest in publicly listed equities. It is not possible for them to invest in infrastructure projects.

Could insurance companies invest in these types of funds? This is what the Financial Times published on January 28, 2015.

Yet Europe's institutional investors are warning that new rules such as Solvency II, which comes into force next year to govern the amount of capital EU insurance companies must hold, threaten to prevent them from filling this funding gap.

The EIOPA published a specific paper on this subject that drew the following comment from the Association of Corporate Counsels

The European Insurance and Occupational Pensions Authority (EIOPA) has published its "Discussion Paper on Infrastructure Investments by Insurers". At 24 pages, the paper's shorter than expected. It also raises more questions than it answers, and gives fewer answers than we thought it would (see our earlier blogs, which are here and here). What the paper does most clearly, however, is draw our attention to how complicated the issues are, and how little time there is left to resolve them. [24]

17. What could investors do?

Investors are the great absents of the Green paper. It is assumed that they will have an interest and be incited to acquire such assets. It is important to look at the terms and conditions at which they might play the role of primary liquidity provider. Without their interest, banks will not play the role of secondary liquidity providers.

Commissioner Hill was wise to mention that the future of a dedicated pensions' stakeholder group for the European Insurance and Occupational Pensions Authority (EIOPA) needed further consultation, and that a simple private funding structure for the regulator should be feasible. [25]

This note explores the key features of ELTIFs, looking, in the sequence of the draft regulation, at:

•authorisation and structural considerations;

•investment powers;

•features in relation to the ELTIF's closed-ended nature;

•transparency; and

•the marketing of these schemes (including the important feature of a second retail passport at product level in the mould of the UCITS approach).

Action: reach out to institutional investors and integrate their needs and objectives in the construction of the CMU.

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18. The Green Paper misrepresents Solvency II as an encouragement to long term financing

Solvency II, will allow companies to invest more in long-term assets by removing national restrictions on the composition of their asset portfolio. (17)

While this comment will not express an opinion on the merits and/or weakness of the Solvency II directive for the European markets, it is certain that Solvency II will not encourage long term-financing within the context of a more robust capital markets in Europe as the Green Paper presumes. Currently, the Solvency II regime is schedule to be fully effective on January 1, 2016—three years prior to the goal set out for a fully functioning European Capital Markets Union by 2019. The Solvency II directive has a series of rules that discourages investment in the long term. Most notably, Solvency II utilizes a market value framework to ensure that the balance sheets of insurance companies have enough capital buffers to deal with any large market disruptions. In doing so, the market value of traditionally safe assets will increase while the values of other long-term assets classes (like infrastructure and real estate) will decrease and insurance companies will seem like they are in a weak capital position, even though their liabilities are due in a distant future and may be able to withstand temporary market volatility. Insurance companies will no longer have as much incentive to hold long-term investments because of the way the market value framework interprets the balance sheets, and will instead turn to assets with shorter maturities and safe assets traditionally not impacted by market volatility.

Right now, insurance companies are the largest institutional investors in Europe with 15.1 trillion of assets under management as of December 31, 2011.[26] If Solvency II is impacting the ability of insurance companies to make long-term investments, this will in turn impact their contribution of liquidity to the European Capital Markets. Maria Koller, the director General of Insurance Europe, made a comment that is illustrative of this point:

"*While the industry welcomes the move to a risk-based regulatory regime and recognises that the final version of Solvency II was improved to avoid a huge negative impact on long-term investments, aspects of the directive and how it is implemented will still require insurers to hold inappropriately high amounts of capital against their long-term investments.*

'This will make it more expensive for insurers to invest in long-term government and corporate bonds, as well as growth-stimulating activities, such as infrastructure projects.' [27]

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[26] *See* Insurance Europe "Funding the Future Insurers' role as Institutional Investors" (June 2013), http://www.insuranceeurope.eu/uploads/Modules/Publications/funding-the-future.pdf

[27] http://www.theactuary.com/news/2014/09/insurers-issue-solvency-ii-investment-warning/

In fact, the European Commission wrote an open letter[28] to EIOPA regarding insurance companies in their role as long-term investors and later a Green Paper[29] concerned with the range of factors that may impact long term financing in Europe. In terms of Solvency II, the Green paper said:

Institutional investors such as insurance companies are suitable providers of long-term funding. While investment by institutional investors in less liquid assets such as infrastructure assets has been limited, the search for higher yields in a low interest rate environment is increasing their appetite for such assets.

Solvency II, applicable from 1 January 2016, will repeal certain investment obstacles, particularly for less liquid asset classes, which currently exist in Member States. Insurers will be free to invest in any type of asset subject to the prudent person principle, whereby they should be able to "properly identify, measure, monitor, manage, control and report" the risks associated with such assets.

It is argued that strengthening capital requirements to capture all quantifiable risks, including market risk (which was not considered in the previous legal regime, Solvency I) may influence the investment behavior and long-term outlook of insurers as institutional investors. For this reason, the Commission asked the European Insurance and Occupational Pensions Authority (EIOPA) in September 2012 to examine whether the calibration and design of capital requirements necessitates any adjustment, without jeopardizing the prudential effectiveness of the regime, particularly for investments in infrastructure, SMEs and social businesses (including securitisation of debt serving these purposes). EIOPA's analysis was provided in December 2013. It recommends criteria to define high-quality securitisation and designs a more favorable treatment for such instruments, by lowering the corresponding stress factors. (5)

In response, EIOPA concluded that there is no justification for lowering the proposed Solvency II market risk charges in relation to certain long-term investments and did not want to extend differential treatment to infrastructure financing and securitizations of SME debt.[30]

If the capital markets union wants to encourage long-term investments and in areas like infrastructure, it must find other ways to do so within the regime of Solvency II. It cannot merely assume that Solvency II directive will in fact strengthen long-term investments or this will impact another area that capital markets can get liquidity from. One option would be to encourage collaboration and resource pooling in order to create institutions that are large enough to make more long-term investments with a risk management system that addresses long-term risks. The CMU must also find ways to address the pro-cyclical behavior of insurance companies selling assets too quickly and not serving as long-term investor

[28] http://ec.europa.eu/internal_market/insurance/docs/solvency/20120926-letter-faull_en.pdf
[29] http://ec.europa.eu/internal_market/finances/docs/financing-growth/long-term/140327-communication_en.pdf
[30] *See* https://eiopa.europa.eu/Publications/Discussion%20paper/Discussion_Paper_on_Standard_Formula_Design_and_Calibration_for_Certain_Long-Term_Investments_20130408.pdf

Action proposal: open a candid and constructive dialogue with the industry to look at the provisions of Solvecy II that negatively influence long-term investments

19. The Green paper assumes that banks have a problem to extend loans

In Europe, most SMEs only approach banks when seeking finance. Although almost 13% of these applications are rejected, it is often because they do not meet the banks' desired risk profiles, even if they are viable. (14)

There seems to be a recurrent theme coming from the European authorities: banks need to be assisted to make loans. They desperately need funding, and even more, cheap funding. This is not confirmed by the observations.

The bulk of the ECB's tsunami of money didn't end up in the "real economy". Most of it never left the banking system's accounts at the central bank.

Loans were at € 17 trillion at the end of the **LTRO operation** in 2014 while they were at € 19 trillion in 2011. That happened while the total assets moved from € 33 trillion to €31 trillion. In other words, it served the banks and the sovereign borrowers. It did not translate into loans.

The same elements risk applying to the new **TLTRO**. This is largely confirmed by the statistics of the European Central Bank. The attraction of the transaction is not in the target that nobody can measure, but in the leverage that banks are authorized to use as a multiple of their loans.[31]

The European Central Bank's targeted long-term refinancing operations (TLTRO) supports bank funding more than lending, says Fitch Ratings. Southern European banks are more reliant on ECB funding and will likely take up this cheap source of liquidity, while many northern European banks are awash with liquidity and may therefore not need the new facility to expand lending.

According to the latest Reports on the Survey on the access to finance of enterprises, bank related products are the most relevant source of finance for euro area SMEs. (61% of the SMEs considered bank loans to be relevant). Notwithstanding, every EU country SME has shown different dependency on this source of funding.

The Report shows that banks are willing to continue and even increase lending for SMEs, especially for small and medium enterprises. The latest results show that small enterprises reported a slight improvement in net percentages for both forms of bank financing (loans and overdrafts), while medium-sized enterprises reported a significant improvement in the availability of bank loans (+14%, up from +6% in the previous survey round) and bank overdrafts (+11%, up from +2% in the previous survey period). Nonetheless, micro enterprises remain highly challenged to access the banking system.

Action proposal: analyze previous initiatives for loans to SMEs that might have been promoted by the Commission and their results

[31] http://www.bloomberg.com/news/articles/2014-09-15/ecb-tltros-unlikely-to-boost-lending-in-south-europe-fitch-says