25 June 2013

Our ref: ICAEW Rep 94/13

Internal Market and Services DG (DG MARKT)
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Dear Sirs

European Commission Green Paper, Long-Term Financing of the European economy

ICAEW is pleased to respond to your request for comments on the Green Paper, *Long-Term Financing of the European economy*.

ICAEW is listed in the Transparency Register (ID number: 7719382720-34).

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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ICAEW REP 94/13

ICAEW REPRESENTATION

EUROPEAN COMMISSION GREEN PAPER, LONG-TERM FINANCING OF THE EUROPEAN ECONOMY

Memorandum of comment submitted in June 2013 by ICAEW, in response to the European Commission's Green Paper, Long-Term Financing of the European economy, published in March 2013

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the Green Paper *Long-term financing of the European economy,* published by the European Commission on 25 March 2013, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. This response draws on ICAEW's areas of expertise represented by several faculties and technical areas, details of which are set out in the Appendix.

GENERAL POINTS

5. The financial crisis has forced governments throughout Europe to identify and attempt to stimulate economic activities that have the potential to underpin long-term growth. Such activities are referred to in the Green Paper as long-term capital goods and there is a presumption that providers of these face a lack of financing.

6. The Green Paper focuses on two providers, large scale infrastructure projects and the SME market, which have hitherto relied on availability of bank debt and where the potential for generating growth has been stymied by declining availability and maturity of bank debt. In each of these areas a review of how individual Member States' initiatives have fared would be a valuable exercise for the Commission to undertake for the Green Paper to have greater impact. Publication of the review results could have the additional benefit of encouraging cross-border capital flows.

7. The Green Paper tries to consolidate thinking on the issue of financing key providers of long-term capital goods; namely public infrastructure and SMEs by way of:

   - greater involvement of institutional investors and other, including new, intermediaries; and
   - significantly more direct capital market financing; and
   - perhaps to a lesser degree, alternative and new forms of finance.

8. Our members have commented that issues relating to the financing of infrastructure and SMEs require very different responses and have questioned this approach. Consequently we have treated the consultation questions as a series of discrete issues, using the opportunity to set out our views that:

   - Structural requirements and the impact of the crisis mean that banks in Europe are likely to play a smaller role in the provision of finance for long-term investment than in the past and this will be centred around short-term bridging facilities, issuing securities to investors and advising on financing structures (Question 3). Consequently there is a strong case for encouraging alternative forms of finance, such as prudent securitisation (Questions 14 and 27).

- There is a role for institutional investors to supply long-term debt finance for infrastructure and SMEs while recognising the trade-off between maintaining the prudential soundness of such institutions and their ability to finance growth (Questions 6 and 7).

- The use of fair value measurements has not been found to have led to short-termism in investor behaviour and a lack of funding for long-term projects (Question 20).

- A dedicated approach for SME markets could help SME issuers to access capital markets but would need to accommodate differences in the profile of SMEs across Member States (Question 28).

9. We observe that the Introduction to the Green Paper notes the need for long-term investment to respond 'to new economic, social and environmental challenges, facilitating the transition to a more sustainable economy…', but the remainder of the Green Paper focuses on the amount of long-term investment rather than the purposes for which it is used. Due to market failures, it is far from automatic that investment will be channelled towards assets that are consistent with a sustainable economy (including the EU's carbon reduction and renewable energy targets) and do not increase lock-in to high carbon infrastructure. Intervention, whether by the Commission or others, may be necessary to address this. A recent report on this topic is *'The Green Investment Report: The ways and means to unlock private finance for green growth'*, published by the World Economic Forum. We recommend that the Commission integrates consideration of the destination of long-term investment in its future work on the supply of such investment.

RESPONSES TO SPECIFIC QUESTIONS

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

10. The analysis is based on the assertion that long-term financing is beneficial yet supply of long-term finance is suboptimal and so steps should be taken to boost this. The assertion is fairly consistent with other current thinking and studies, both at individual Member State level and on a multinational level. We think this analysis would have had more resonance if it was given more context, ie by setting out current levels of long-term investment in the different Member States, analysed by major categories, an analysis of how that measures up against specified criteria, and then an assessment of the extent of a funding gap. A similar approach for financing of SMEs would also have been insightful.

11. The analysis sets out matters that currently prevent potential providers of long-term finance (governments, corporates, households and external financing/ foreign direct investment (FDI)) from supplying the desired level of such finance. The analysis also introduces the concept of economic activity that leads to long-term capital goods such as economic and social infrastructure, buildings and R&D, education and innovation. On the basis of the above, long-term financing is deemed as being financing for long-term capital goods.

12. This would have been a good inclusive basis from which to consider the landscape and trends. However likely trends are not discussed[1] and the focus of the remainder of the paper is markedly narrower. The remainder is devoted to two economic activities that lead to long-term capital goods - infrastructure and the SME sector. In particular it considers what improvements are needed to capital and financial markets that would result in better funding of these activities. However certain issues tackled (corporate governance arrangements and financial reporting) are secondary to the main question of the role of capital markets.

[1] A good exposition of these may be found in the Group of Thirty's publication Long-term Finance and Economic Growth (2013)

13. In summary we do not disagree with the thrust of the analysis itself, but the main rationale of the Green Paper is rather unclear. There are at least three issues; namely: what is the role of markets in providing long-term financing? What are the challenges in financing public infrastructure? Is there a role for capital markets' financing of SMEs? The Commission should bear this in mind when evaluating responses to the Green Paper.

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

14. We think the analysis provides a useful definition with which to frame the examination of the supply of long-term financing for the production long-term capital goods.

15. Any definition will be arbitrary to some extent as there is a continuum of potential maturities for finance. Moreover, even within 'long term' projects there may well be a need for shorter-term financial facilities, for example to help smooth the profile of cash flows. Nonetheless, the definition of long-term financing would best be focused on its 'long' maturity.

16. Taking investment that is 'long term' from the viewpoint of the recipient of the funds, there is an important distinction between funding through financial instruments which themselves are traded in reasonably liquid markets, as opposed to those that are not. In the case of the former, the investment does not necessarily have to be long term from the perspective of the holder of the asset. That is the classic rationale for trading arrangements such as conventional stock exchanges.

Q3: 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?

17. We agree with the Green Paper that banks in Europe are likely to play a smaller role in provision of finance for long-term investment than in the past. There are both shorter term and structural reasons for this.

18. In the shorter term, much of the European banking system continues to experience stress as a result of the financial crisis (including from losses on legacy assets). Structurally it is also facing both market and regulatory pressures to strengthen prudential standards, particularly with regard to capital and liquidity.

19. Tougher capital requirements are prompting banks to shrink rather than grow their balance sheets, and to have limited appetite for higher risk lending – and longer-term investment tends to be higher risk, if only because of the time horizon involved. As banks seek to reduce their higher risk activities we would expect to see a reduction in lending for productive activities and business expansion.

20. On the liquidity side, regulatory rules are reducing the extent of maturity transformation in the global banking system, making it more difficult for long-term investment to be financed from banks' principal source of funds, namely short maturity deposits.

21. Given the return to banks' reliance on deposits as a source of funds for lending it is questionable whether they will ever again be well placed to play a significant part in directly financing long-term investment. The pressures noted above will limit banks' capacity for the foreseeable future. This means that banks' main contributions are likely to be in areas such as advising on financing structures, issuing securities to investors and possibly providing short-term 'bridging' liquidity facilities. This suggests that within the banking sector as a whole, investment banks are likely to be important players in facilitating longer-term finance.

Q4: 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?

22. We have no comment.

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

23. We have no comment.

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

24. There is a role for institutional investors to supply long-term *debt* finance for infrastructure and SMEs.

25. There is a generally accepted potential for a role for institutions in financing infrastructure projects. For investors such as insurers and pension funds, infrastructure investment provides a good match for the institutions' long-term liabilities and can generate high quality revenues. The sector itself regularly confirms its interest in investments that meet the risk/return criteria of its members' mandates.

26. A number of challenges need to be overcome to achieve significant commitment from institutions. For instance, prudential regulatory reforms such as Solvency II rules for insurers should not thwart the development of instruments for institutions to invest in infrastructure. In this context we note the announcement on 23 May 2013 that the proposed Directive for improving the governance and transparency of occupational pension funds (IORP) will not address the subject of pension funds' solvency.

27. Furthermore, regulatory certainty and, at Member State level, visible deal flow and commitment to long-term policy are necessary to convert institutional interest into investment.

28. The feasibility of institutions providing long-term financing for SMEs has been explored at a number of levels, including in a recent study[2] conducted for the UK Department of Business, Innovation and Skills which promoted redevelopment of the SME loan securitisation market as a way of enabling SMEs to access the public corporate bond markets.

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?

29. Some of the liabilities of insurers and reinsurers are long term; the same is true of most pension fund obligations. Against this background such entities are natural holders of longer-term assets.

30. Nonetheless, there remains a potential trade-off between prudential soundness and promoting growth, because from a narrowly prudential perspective low credit risk assets, such as some types of government bonds, are preferable to investments in the 'real' economy, particularly longer-term assets where generally credit quality over the life of an exposure will be less certain.

31. However, the financial strength of an insurance company or reinsurer also depends on the return on its assets, and in this respect long-term investment is likely to prove superior to holding low risk, shorter-term assets.

32. If - despite this - there remain concerns that prudential requirements for insurers could disincentivise longer-term investments, in principle there is some scope to rebalance the risk weights among different classes of asset, for example lowering those on longer-term infrastructure investments and raising them on short-term financial instruments. That could be done while keeping the total capital requirements for insurance companies roughly unchanged.

[2] An Agency for Business Lending: Improving access to finance for small and medium-sized enterprises (October 2012), www.AFME.eu

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

33. We have no additional comments to those set out in our response to Question 6.

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

34. We have no additional comments to make.

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?

35. At present and for some years to come the availability of finance from banks will be affected by the impact of the crisis on the banking system together with pressure from the markets and regulators to strengthen both capital and liquidity. The numerous different regulatory initiatives in particular have created a cumulatively powerful incentive for banks to focus on reducing their balance sheets and loan book, rather than on expanding credit supply.

36. Moreover, more stringent capital requirements have had the effect of making many banks capital constrained, in the sense that they are finding it challenging to meet the capital needed to support their balance sheet. This has probably made the banking system more procyclical, as economic upswings are likely to ease this constraint as banks' profits rise, but equally any economic downswing is likely to tighten the constraint sharply as banks' capital may be eroded through losses.

37. In view of the crisis, there is little doubt that a marked strengthening of the prudential environment was required. However, in principle if a by-product of this is to prevent investment taking place which has a clear economic return, there may be a case for public sector bodies to fill any funding gap. In the case of long-term investment, the body best placed to do this would probably be the European Investment Bank (EIB).

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

38. We believe that it would be inadvisable to make Europe-wide changes to capital market financing. The economies of Member States are at very different stages post crisis and therefore will have very different priorities for market interventions.

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?

39. We refer the Commission to proposals for developing debt and equity markets in order to promote a broad spectrum of financial instruments in the Group of Thirty publication *Long-term Finance and Economic Growth*.

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

40. We have no comment.

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?

41. Securitisation allows pools of loans or securities to be packaged together in ways which are likely to be attractive to investors. As such it offers the opportunity to free up scarce capital and funding in Europe's banking system. Unfortunately, it has received a bad name as a result of

various excesses in the run up to the financial crisis. These shortcomings included a lack of information about the characteristics of the assets in pools being securitised; inaccurate ratings of securitisation tranches by rating agencies; and excessively complicated structures, epitomised by CDO-squared instruments. However, prudent securitisation is a valid and useful financial tool.

42. The key to a revival of securitisation in Europe will be a commitment by originators to use straightforward structures in which:

- the pool underlying a particular securitisation is capable of being described transparently and in particular is fairly homogeneous; and
- the tranches are all referenced directly to that pool, rather than being layered in complex ways. If these conditions were met it would facilitate production of reliable ratings.

43. Given the pressures on banks to de-leverage, they are unlikely to be large scale purchasers of securitisations. This means that a market needs to be developed amongst other potential investors, including longer-term investors such as insurance companies and pension funds.

44. In addition, revival of the market may require some stimulus from the official sector. For example, to foster liquidity of the market, central banks could buy and sell tranches in their official monetary operations. Furthermore, the European Investment Bank could underwrite securitisation issues or mitigate credit risk, for example through providing appropriate credit enhancements on commercial terms.

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?

45. We have no comment.

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

46. The ability to deduct debt interest for tax purposes is commonplace in the tax regimes, in one form or another, in most developed nations (within and outside the EU), no doubt based on the fact that debt interest would be deductible for the borrower while interest income would be taxed on the lender. This system tends to encourage debt finance rather than equity finance, although it must be remembered that tax is only one part of the decision to use debt over equity and much will depend upon the prevailing economic and financial circumstances and bank lending policy.

47. The conclusion of the Mirrlees Review of the UK tax system published in 2009 was that debt and equity should be treated in the same way – although its recommendation was to provide relief for corporate equity rather than restrict interest relief.

48. Further, in relation to the UK and we suspect other EU countries it must be remembered that not all debt interest is tax deductible and there are a number of rules that restrict tax relief in certain circumstances, particularly if it is incurred as part of a tax avoidance arrangement. On balance we are not convinced that a compelling case has yet been made to change the existing rules, but it would benefit from further research.

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?

49. In principle, we support market mechanisms to achieve more sustainable outcomes. However we are not convinced that the tax system is the best mechanism to incentivise long-term saving, although it can be and is used for such purposes, notably in pensions.

50. The particular challenge is that if the tax system is used to incentivise long-term saving then the tax system must be stable and provide certainty of treatment.

51. Unless the tax treatment is fixed, or there are proper grandfathering rules, then taxpayers have no guarantee that the tax regime when they begin to draw down benefits will resemble that when they made the savings. In the UK, for example, a new, pretty generous pensions regime was established in 2007, which has since been subject to a number of changes and restrictions. These changes, and the prospect that more are in the pipeline, have undermined the use of pensions as a suitable savings vehicle.

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?

52. This is a difficult question to answer. In principle, we would favour a wide tax base with relatively low rates which would suggest keeping the number of incentives to a minimum. However, governments generally are anxious to encourage increased growth and capital investment, the rationale being that the resulting tax revenues from increased growth will exceed those that might otherwise have been collected. By way of illustration, the UK, is adopting what might be termed a 'mix and match' policy, with lower corporation tax rates coupled with a number of specific investment incentives such as the Patent Box regime. Without detailed empirical evidence it is not always clear whether such strategies work, and such evidence is only likely to be forthcoming after the policy has been implemented.

53. We are concerned that when tax incentives are introduced to encourage social and /or economic behaviour, they can create distortions and encourage taxpayers to engage in behaviour which seeks to secure the tax relief, but which runs counter to what the particular tax incentive is designed to achieve.

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

54. Because tax coordination requires unanimity amongst the Member States it has been extremely difficult to arrive at pan-European tax decisions. Even the enhanced cooperation route available under the Lisbon Treaty provisions has been difficult to achieve, see for example the current attempt to introduce a Common Consolidated Corporate Tax Base.

55. Given these difficulties and the absence of a convincing case in this paper that deeper coordination would result in a demonstrable improvement, we are not convinced that tax coordination has much of a role to play in supporting the financing of long-term investment.

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?

56. We are not aware of any evidence that the use of fair value measurements has led to short-termism in investor behaviour, and we consider it unlikely that it has done so.

57. The Green Paper states that 'some research highlights a reduction by institutional investors in equity allocations in investment portfolios, since equity is considered more volatile and risky than bonds'. The implication is that the reduction in equity allocations is attributable to the introduction of fair value accounting. The only empirical evidence on this point that we are aware of relates to investments by defined benefit (DB) pension schemes in the UK and the US. This does indeed suggest that there is a correlation between the adoption of fair value measurement of pension scheme assets and a shift out of equities and into bonds. But the research literature also identifies other possible causes of these developments so far as the UK is concerned, including:

- The closure of DB schemes to new entrants at this time meant that their remaining members were on average moving closer to retirement. It is common practice for pension funds to shift their investment balance towards bonds as their members approach retirement, and their pensions become payable.

- The tax position of investment in equities became less advantageous during the period in question.

- Thinking about the best way to finance pensions was in any case shifting at this time, and the wisdom of relying heavily on equities rather than bonds was increasingly questioned for reasons that had nothing to do with accounting. The key point here is that, as the Green Paper points out, investment in equities 'is considered more volatile and risky than bonds'. Those who argued in favour of reducing DB pension schemes' investment in equities questioned the suitability of using volatile and risky assets to finance stable and predictable long-term obligations.

58. A more fundamental point is that it is not clear why the Green Paper assumes that a shift by DB pension schemes (or any other group of investors) away from equities and towards bonds is detrimental to the financing of long-term projects. Provided the bonds are long-term bonds, which we believe is usually the preference of pension funds, then they seem as fitted as equity to financing long-term projects. No doubt such projects need an appropriate mix of equity and bond funding, but a shift in preferences among one group of investors should not make it more difficult to achieve the desired mix. The relative returns required for the two types of finance may change if available funding increases in one category and decreases in the other, but the overall cost of funding would not necessarily change.

59. The Green Paper also states that 'Other research argues that market-consistent valuation may encourage long-term investors to increase their risk exposure, if the volatility is recognised outside their profit and loss accounts.' We are not aware of any academic research on this point, although this argument is noted in the OECD working paper *The Effect of Solvency Regulations and Accounting Standards on Long-Term Investing* (2012). As the wording of the Green Paper indicates, the argument is about what may happen if certain accounting policies are adopted. It is not, as far as we are aware, an empirical research finding. We would in any case urge the Commission to be careful what conclusions it draws on this question. The assumption underlying the argument seems to be that either the market is fooled if profits and losses appear in other comprehensive income (OCI) or that managers of investment entities think the market (which includes themselves) is fooled if profits and losses are reported in OCI. Neither assumption seems particularly plausible.

60. As the Green Paper acknowledges, fair value can provide useful transparency for investors. Its use is restricted by standard setters to those items where it provides more useful information than historical cost, and we believe that the current extent of its use is broadly supported by investors in their capacity as users of financial reporting information. It would be extremely unfortunate if pressure were put on standard setters to move away from the current limited use of fair value because of unfounded ideas about its effect on the availability of funding for long-term projects.

61. Although this point is not directly relevant to Question 20, in the discussion preceding it the Green Paper states that 'Fair value accounting principles … may … be detrimental to stability' (page 13). We assume that this comment reflects a view of the financial crisis held in some quarters. To date, and researchers have now been raking over the evidence on this question for some years, there appears to be no empirical support for the claim that fair value accounting contributed significantly to the financial crisis. A useful summary of relevant research to 2010 is provided by Mary Barth and Wayne Landsman, 'How did financial reporting contribute to the financial crisis?', *European Accounting Review* (2010). More research recent tends to confirm earlier conclusions: eg, Brad Badertscher, Jeffrey Burks and Peter Easton, 'A convenient scapegoat: fair value accounting by commercial banks during the financial crisis',

The Accounting Review (2012) and Christian Laux, 'Financial instruments, financial reporting, and financial stability', *Accounting and Business Research* (2012).

62. This is not to suggest that financial reporting information is irrelevant to the business cycle. As companies tend to do well in the good times and poorly in the bad times, all sources of information about economic performance that accurately reflect what is happening tend to promote a feeling of optimism in the good times and pessimism in the bad times. No doubt this adds fuel to the business cycle. But it seems to be inevitable unless people are to be misinformed; it is not the product of any particular method of accounting, and it is not the product purely of corporate financial reporting information.

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

63. Incentives may help change investment culture to promote better long-term shareholder engagement. However, such incentives need to be part of a co-ordinated plan as individual measures are unlikely to be effective in isolation. We believe that more discussions need to be had before individual incentives may be devised, reflecting on experiences in Member States.

64. For the record, we would not be in favour of incentives such as differential voting rights or of regulatory measures that penalise 'short-term' holdings. The ability of companies to raise equity finance is partly dependent upon the subscribers being able to sell their shares at a later date should they wish or need to do so. If rights are differentiated between long and short-term holders then it may become difficult for long-term holders to be able to afford to sell their shares. (The would-be buyer will pay only for the low income stream that he will receive, and this will not compensate the would-be seller for foregoing a high income stream. The seller will become locked in and unable to afford to sell – unless of course the financial markets develop a contract that allows the long-term holder to remain the legal owner in name but sell the benefit of his income stream to someone else, which would defeat the policy anyway.) In turn that may make would-be subscribers less likely to subscribe for equity capital in companies in the first place.

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

65. For mandates and incentives to be effective, they will need a broad support from those concerned and affected. We suggest more in-depth consultation and evidence gathering to be held in the process.

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

66. We would support a review of how different Member States apply the concepts of fiduciary duty in relation to directors and equivalent 'duties' of asset managers and investors.

67. We believe these duties are collectively important to long-term financing. In an illustration of this importance, a concept of stewardship consistent with relevant fiduciary duties is applied to institutional investors and asset managers by way of the UK Stewardship Code. The review by Professor John Kay of UK equity markets and long-term decision making (2012) makes recommendations in relation to the issue and the UK Government, in response to those recommendations, has asked the Law Commission, a statutory body that reviews law and makes recommendations to government, to review the legal obligations arising from fiduciary duties. The outcome of the Law Commission's work should be useful for the purpose of the European Commission's review to revisit the concept (at least to the extent it relates to UK law), if appropriate.

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?

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

68. It is widely accepted that non-financial information has an important role to play in corporate reporting, and initiatives such as the proposal for a Directive on disclosure of non-financial and diversity information and the International Integrated Reporting Council's draft framework will no doubt contribute to improved non-financial disclosures. There has already been significant progress in this area in recent years, with much more attention paid to management commentary and improved risk disclosures, for example.

69. Much non-financial reporting is intended to help users to assess a company's prospects rather than its past performance, and even information on past performance is of course of interest to many users primarily because it helps them to assess the company's prospects. It may be that the thinking behind Question 24 is really aimed at assessing long-term prospects rather than past performance. If so, then we agree that both financial and non-financial information are needed to assess a company's prospects.

70. Reporting on performance, however, is a backward-looking exercise, and reporting on long-term performance implies historical accounting information that covers a long period of the past. It must be doubtful how useful this would be. Investors are more interested in a firm's long-term prospects than in how it has performed over the past 10 or 20 years. This is mainly because how a firm performed 10 or 20 years ago is not particularly relevant to assessing its future prospects, but also because changes in the firm's structure and activities as well as changes in accounting are likely to make meaningful and internally consistent data covering the long term difficult to obtain.

71. Whether closer integration of financial and non-financial information will be helpful in assessing a firm's long-term prospects is unclear. While both types of information are necessary and they should complement each other, how far they can usefully be integrated (other than in obvious ways like avoiding overlaps and having cross references) is another matter. It may be more useful to think of them as separate but complementary, rather than as a single integrated unit.

72. We do not know what sort of long-term benchmarks the Commission has in mind, and we have nothing to suggest on this point. Even long-term benchmarks, whatever they may be, will need to be updated regularly and the result is likely to be that – if they are updated quarterly, half-yearly or yearly – attention will focus on the change since the last time they were updated. This could introduce a new form of what some would regard as short-termism. The market takes whatever information it can find in forming views on the long-term value of firms and projects. Much of this information may be 'short-term', but the market's use of it does not mean that the market is short-termist in its outlook.

73. Care will also have to be taken to find benchmarks that are appropriate for the industries or investment types to which they are to be applied, as it is unlikely that one benchmark or set of benchmarks will work for all types of long-term investment project.

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

74. ICAEW is interested in promoting the range of forms of finance and its freely available publications include *SME Finance*, published in conjunction with the UK's department for Business, Innovation and Skills and *Private equity demystified*, which appears on the recommended lists of several leading business schools.

75. In 2012 ICAEW held a roundtable on supply-chain finance and asset-based lending to help inform the review of alternative sources of finance for UK businesses commissioned by the UK

government (the Breedon review). The UK government has, through its Business Finance Partnership, invested in non-traditional lenders offering such products to SMEs.

76. Equity finance is important for certain companies but we do not see the need for significant regulatory change at EU level in order to facilitate SMEs' access to equity capital markets. Our members generally believe that the regulatory regime is about right; notwithstanding this there may be a case to revisit aspects of the proportionate disclosure regime such as prospectuses for rights issues.

77. We also do not consider that significant structural reforms are needed to enable SMEs to raise public or private equity capital. There are different markets that currently cater for companies - including those classified as SMEs - to list at various stages of development and growth and we would not encourage initiatives that seek to impose a market structure too far down the chain. The new EU venture capital regime will help provide access for SMEs to private equity.

78. For SMEs too small to be able to access existing equity capital markets cost-effectively, 'crowd-sourcing' using the internet may become significant. Similarly, for SMEs too small to be able to access existing debt capital markets cost-effectively and which lack the asset base desired by banks or asset-based lenders, 'crowd-sourcing' of debt using the internet may become significant. Clarification of the regulatory constraints on raising small amounts of equity and debt from individuals needs to be examined, to allow reasonable access to this type of finance (including for early-stage inherently high-risk ventures) without putting retail investors at risk of excessive losses.

79. In terms of debt finance, we also support promotion of securitisation of SME loans.

80. As the question focuses on potential reforms, we take this opportunity to set out our position on the question as to whether smaller listed companies in the EU should be able to comply with the *IFRS for SMEs* rather than with full IFRS. This point is viewed by some as a barrier to SMEs accessing capital markets. In our view, all listed companies should continue to be required to comply with full IFRS. We believe that when a company's shares are publicly traded, it should – regardless of its size – have obligations to disclose information to help ensure that its shares are fairly priced and to assist shareholders in exercising appropriate control over managers. While the *IFRS for SMEs* provides a very useful basis for reporting by unlisted companies, it was not written with listed companies in mind, and we do not believe that complying with it would provide the disclosures that investors in listed companies have a right to expect.

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?

81. It is generally acknowledged that direct access for smaller SMEs to the corporate bond market is a complex matter due to liquidity concerns, lack of credit ratings and issue size.

82. We would support efforts that focus on creating a responsible securitisation market for SME loans and we see a role for the EIB in mobilising financial intermediaries' capital for lending to SMEs by way of guarantee. Further to a recommendation of the Breedon Report, ICAEW participated in a UK industry-led feasibility study for provision of long-term capital to smaller businesses. The study concluded that the challenges set out above could be overcome by way of aggregation; ie pooling packages of SME loans and financing them on the capital markets by issuing debt backed by these loans. The EC could usefully consider the common principles and operating procedures for this aggregation proposal which are set out in the UK study, An Agency for Business Lending: Improving access to finance for small and medium-sized enterprises. We understand that EU state aid approval for the UK's aggregation proposal is pending.

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?

83. We would support a dedicated approach for SME markets that improves access to finance for SME issuers by addressing issues that currently restrict investment in this asset class.

84. A dedicated EU asset class could, for example, help rectify information asymmetries with the development of common rules/guidelines that, inter alia, would

    - stimulate research into smaller companies;
    - enable consistent evaluation of their credit standing; and
    - promote, where appropriate, consistent constraints on raising debt and equity from individuals within the EU.

    It would also provide a consistent bar for evaluating the impact of future regulation of SMEs.

85. A dedicated approach would need to be sufficiently flexible to accommodate differences in the profile of SMEs in different Member States.

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

86. An EU regulatory framework could help the development of non-bank sources of finance for SMEs providing it recognises that SME and growth markets in Member States are not homogeneous and vary as to the size and nature of the companies supported, the profile of the investor base and the regulatory and structural environment.

87. Moreover, from the perspectives of investor protection and market credibility, the framework should promote consistent and appropriate standards and would need to avoid facilitating access to capital to companies that are not investment ready or that do not demonstrate the minimum standards for each form of finance.

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?

88. The Commission may also wish to consider the broader impact of government policies. It is difficult for investors to take long-term positions and to maintain them if governments constantly change their policies on matters such as taxation, incentives for investment, planning laws, and environmental controls. If governments wish to promote long-term investment, they need to make policy choices that they are prepared to stick with for the long term. Governments may respond that this is impracticable and that they must always be ready to respond to changing circumstances. But the same is true for investors.

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APPENDIX

This response draws on the expertise of ICAEW members that is represented in the areas below:

The Corporate Finance Faculty is the voice of corporate finance within ICAEW and the UK's largest representative body of corporate financiers. The faculty is responsible for submissions to regulators on behalf of ICAEW. It provides a range of services to over 6,000 members, including a monthly magazine *Corporate Financier*.

The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including *TAXline*, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

The Corporate Governance Committee includes representatives from the business and investment communities. The Committee is responsible for ICAEW policy on corporate governance issues and related submissions to regulators and other external bodies.

The Business Law Committee includes representatives from public practice and the business community. The Committee is responsible for ICAEW policy on business law issues and related submissions to legislators, regulators and other external bodies.

The Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues facing the financial services industry acting free from vested interest. It draws together professionals from across the financial services sector and from the 25,000 ICAEW members specialising in the sector and provides a range of services and provides a monthly newsletter *FS Focus*.

ICAEW believes that sustainability is one of the biggest challenges facing business today. Our sustainable business thought leadership work examines the action, activities, and obligations of businesses in achieving a sustainable world. We work at the forefront of debate around how markets can promote sustainable business and how this creates opportunities for our members and the wider business community.

The ICAEW Europe Region is headquartered in Brussels and brings a pan-European perspective to ICAEW's work through regular interaction with professional bodies, firms, oversight authorities and market participants across Europe. It also engages with approximately 5,000 members in EU member states outside the UK. ICAEW is listed in the Transparency Register (ID number: 7719382720-34).