ICAEW REPRESENTATION
73/15

EUROPEAN COMMISSION GREEN PAPER, BUILDING A CAPITAL MARKETS UNION

ICAEW welcomes the opportunity to comment on the consultation *Building a Capital Markets Union,* published by the European Commission on 18 February 2015, a copy of which is available from this link.

This ICAEW response of 13 May 2015 reflects consultation with the Corporate Finance Faculty, the Financial Reporting Faculty, the Financial Services Faculty, the Tax Faculty, the Finance and Management Faculty, the Business Law Committee, the Corporate Governance Committee, the Sustainability Committee and the Insolvency Committee. Information about these areas of expertise may be found in the Appendix.

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

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SUPPORT FOR THE VISION OF CAPITAL MARKETS UNION

1. We are pleased to have the opportunity to submit our views on the Green Paper. The European Commission's proposal for a Capital Markets Union has prompted debate and a wide range of considered policy contributions. From our engagement with members and other market participants, we are optimistic that this idea should provide a boost for jobs and sustainable economic growth for all Member States, but its success will require measures which lead to genuinely incremental funding. In some parts of the European Union, businesses do have access to funding from alternative finance models. Efforts to fill gaps and make options more widespread across Member States should both build on, and avoid disruption to, areas of success.

2. A recurring theme of ICAEW and other SME research across Europe, highlights the asymmetry of funding information as a barrier - not simply the lack of funding – and the need for better use of existing funds as well as information and professional advice on the variety and sources of funding. ICAEW, together with 19 other leading industry and professional organisations, is seeking to address information asymmetry in the UK, in part via a comprehensive Business Finance Guide. A similar European initiative would be extremely valuable.

3. We envisage a CMU that:

- supports a dynamic, growth-oriented EU;
- enables businesses to access innovative and competing alternative channels of capital, alongside banking finance;
- operates within and across all Member States; and
- is underpinned by minimum common elements.

4. With over twenty years' engagement in Brussels, we have a track record of helping to achieve a deeper single market. Our response draws on our experience of previous EU initiatives, many of which have had a significant and lasting impact. Others have not delivered the expected benefits and should provide lessons. As the many contributors to our publication on Europe's future in global markets made clear, we need a strong single market which is open to the rest of the world in order to meet the challenges of the next twenty years. An integrated and open market requires transparency and comparable information if it is to work properly – a key theme of our response.

5. The financial crisis has prompted a number of market-led proposals and initiatives, many of which can form valuable groundwork for achieving the aims of CMU. We agree with the sentiment in the Green Paper that in many circumstances market players may be able to develop better responses to perceived obstacles. We highlight initiatives such as the development of environmental, social and governance (ESG) investment guidelines or private placement markets.

6. We believe that a great deal can be achieved by looking at practical issues which stand in the way of innovative practices taking root. There is a major role for the Commission in facilitating the exchange of best practices. There would be great value, for example, in sharing practices that encourage data flow, such as ones that connect companies and capital, or promote financial literacy, or help make professional advice on funding solutions more widely available to businesses.

7. ICAEW chartered accountants bring experience and expertise in corporate finance, financial reporting, corporate as well as environmental and social governance, financial management, financial advisory, audit and assurance, tax, business law and sustainability. We will continue to bring ideas to the table and to the measures that we believe are most necessary for achieving CMU aims.

8. We will be particularly keen to contribute further to CMU where the Commission considers 'public good' measures, facilitating the flow of information or helping to create suitable conditions to boost capital markets across the EU, such as in the areas below:

- impact assessment of the AIFMD and EuVECA (see our responses to Qs 1, 3, 11 and 14);
- developing a Europe-wide investor map (Q5);
- considering 'use of proceeds' principles to target investment (Q7);
- getting banks to share credit data (Q9);
- obliging banks to refer businesses to alternative providers of finance (Q9);
- sharing customer data with a central counterparty (banks) (Q9);
- development of common best practice standards for crowd funding (Q9);
- pan-European review of national restrictions on the allocations of institutional investors into certain asset classes (Q10); and
- common standards of protection for retail investors and savers (Qs 17 and 20).

9. Having competing markets within the EU, underpinned by minimum common elements, will enable the EU to be stronger and achieve growth. The extent of need does, of course, vary at national level and this is for institutional factors as well as economic and financial ones. Future measures that ignore proportionality and subsidiarity are likely to be counter-productive to the aims of CMU. They will cause damage where there is no market failure and also risk 'closing' markets in the EU to investment, including from third countries.

10. We are, thus, more likely to highlight pitfalls and negative unintended consequences should the Commission embark on future measures that:

- pursue harmonisation of capital markets that limits competition within the EU (Qs 1 and 21);
- jeopardise remaining in the 'IFRS family' (Q8);
- move towards giving unnecessary roles to the European Supervisory Authorities; and
- develop regulatory initiatives in other policy areas that might have unintended negative consequences on the establishment of CMU.

RESPONSES TO SPECIFIC QUESTIONS

Priorities for early action

Q1: Beyond the five priority areas identified for short term action, what other areas should be prioritised?

11. We support the focus on jobs, growth and access to funding for European SMEs. We also agree with the five priority areas identified and welcome the Commission's stated openness to market solutions.

12. In that context, we urge the European Commission to refine and better articulate the concept of capital markets union (CMU). This would strongly enhance public understanding of the anticipated outcomes; ie, why is CMU relevant to the European citizen? Future CMU-related actions can either reference, or be underpinned by the concept. The Commission can also ensure that future policy initiatives in other areas will not have an adverse impact on the concept of CMU.

13. While endorsing the Commission's stated objectives of CMU, we believe that missing from the Green Paper is recognition that the notion of a 'one size fits all' EU economy may be detrimental to the Commission's aims. For example, reference is made to differences between Member States and the need to accommodate them, but this acknowledgement does not, in general, influence significantly the proposed or possible measures for regulatory action or attention, such as standardised credit information on SMEs, standardised corporate bonds and standard pension products.

14. The concept of CMU, as outlined in the Green Paper, should further reference the need for proportionality and subsidiarity. This is fundamental to the functioning of the EU and, more specifically, to European decision-making and provides that competition between markets that meet a required, minimum standard is to be encouraged. A diversity of economies can be a source of innovation and growth. What is needed is a dynamic union, which encourages innovative and competing alternative channels for accessing capital (as well as bank finance) in all Member States. Common minimum standards, which allow local variation within a national context, will encourage new forms of, or channels for, capital to flow to enterprises and competition with economic benefits. Excessive regulation, conversely, may stifle growth and innovation.

15. As a secondary priority, we also suggest that the review of the AIFM Directive should be expedited. The Prospectus Directive and AIFM Directive regimes represent existing steps towards CMU with the promise of a pan-European passport for issuers and registered fund managers, respectively. The Green Paper touches on similar steps around eg, personal pension provision and UCITS. Transposition of such regimes across Member States is, in the short term at least, onerous and costly. The removal through regulation of cross-border barriers to capital flows is not generally sufficient to increase such flows across the EU. It is therefore important first to assess and evaluate the economic impact of the PD and the AIFMD. This will help shape future potential actions such as encouraging take-up of ELTIFs. An early review of the PD is running concurrently with the Green Paper consultation and we believe that the review of the AIFMD should be brought forward.

Q2: What further steps around the availability and standardisation of SME credit information could support a deeper market in SME and start-up finance and a wider investor base?

16. We support an increase in the availability of credit information. We agree that encouraging all Member States to adopt practices that increase the availability of such information would be worthwhile and consistent with the Commission's stated priority for the development of securitisation of SME loans. Although availability of credit information is not a guarantee of capital, making it common practice will make it easier for investors (including from outside the EU) to research businesses in individual Member States and, thus, open up opportunities for capital. Availability of credit information in all Member States should make less likely the unintended consequence of capital flowing from less developed markets to businesses that disclose such information and operate in markets where capital is already more easily available.

17. In this respect the Commission can play a valuable role in analysing the impact of relevant steps already taken by individual Member States to boost availability of credit information. We have been broadly supportive of the aim of recent measures adopted by the UK government that may boost the availability of SME credit information. The outcome of these measures which are described in paragraphs 18 and 19 and are intended to be in operation by mid-2016, will not, however, be known in the short term. The Commission might consider monitoring the impact of these measures and of ones in other Member States, on enabling business to access alternative sources of finance and on widening the investor base.

18. In the first instance, the UK government has embarked on a radical approach to opening up access to credit data held by the big banks which has proved a barrier to entry in the market for lending to smaller businesses. The new measures giving the credit reference agencies access to the credit data held by the banks should increase the reliability of credit scores and enable alternative finance providers to make better-informed decisions about finance provision to smaller businesses. It would also assist new entrants in gaining access to the proprietary customer base of the banks, which is difficult and costly to access.

19. Under the second measure, where a small business is rejected for finance by a bank, the bank will be obliged to offer the business a referral to an on-line finance platform. These platforms will give alternative finance providers the opportunity to offer viable businesses the finance they need. The ultimate aim is for new finance platforms to be created so that lenders can find viable businesses that are looking for a loan, but have been rejected by a designated bank. Whether these new funders will be prepared to support businesses identified by (in some cases, existing) banks as unsuitable for further funding is as yet unproven.

20. The Commission's planned workshops on SME credit information could also research demand for and the requirements of likely users of SME credit information, and could usefully deliver relevant key information metrics and principles for simple, common disclosures. An individual Member State can then decide the extent to which the metrics can be adopted, without imposing costs (such as those to do with maintaining data) on businesses that need only sporadic access to capital, and without conflicting with national laws. Potential undesirable consequences associated with preparation and disclosure of standard credit information would include inadvertent disclosure and data leaking into the public domain, including via breaches in cyber security.

21. We are currently not persuaded that measures to standardise credit information at a European level would address the needs of SMEs in different Member States. Such measures could jeopardise existing systems that already work well. In addition to the practical language hurdle, we believe that standardisation would be an ill-advised priority for a number of reasons.

22. For one thing, standardised information about a business, while more easily comparable, will not guarantee debt being provided to businesses. In addition, providers of funding to start-ups tend to set their own information requirements. Thirdly, investors tend not to invest in businesses, sectors or national markets that they do not understand or that they perceive are too risky. Having standard data on credit risk will not alter these basic principles of lending and investing (although it can help inform them).

23. Finally, in this context, the Commission may wish to monitor the impact of the 2013 EU Accounting Directive, which limits the information that can be mandated by Member States in the annual financial statements of small and micro businesses.

Q3: What support can be given to ELTIFs to encourage their take up?

24. We do not comment on specific support measures for encouraging ELTIFs take-up.

25. However, in view of the fact that only EU alternative investment funds (AIFs) that are managed by alternative investment fund managers (AIFMs) will be eligible to market themselves as ELTIFs, we reiterate our comment about the need for a cost/benefit review of the AIFMD (see our responses to Qs 1, 11 and 14).

Q4: Is any action by the EU needed to support the development of private placement markets other than supporting market-led efforts to agree common standards?

26. We have no comments.

Measures to develop and integrate capital markets - Improving access to finance

Q5: What further measures could help to increase access to funding and channelling of funds to those who need them

27. We would encourage the Commission to consider implementing measures to address the asymmetry of funding information in ways that would help the different stakeholders. In implementing these, the Commission could seek the support of intermediaries, such as professional bodies of accountants, which have close insights into businesses.

For businesses:

28. The Commission should further promote practices across Member States to enable businesses to obtain professional advice and to raise awareness and understanding of funding sources and the stage of business growth to which they typically correspond.

29. CMU aspires to reduce reliance on bank financing but this should not result in inappropriate business take-up of alternatives to bank lending. Awareness initiatives should recognise stages of business growth and national legal and cultural barriers to take-up of alternative forms of finance. (Under Additional Information, we have uploaded the publication The Business Finance Guide, a joint publication between ICAEW and the British Business Bank, which sets out finance considerations and options for businesses at various stages of business growth.)

30. It is also important that businesses understand the typical requirements of each source of finance, be they market- or regulation-driven. As an example, businesses seeking later stages of finance, will need to be able to demonstrate the more onerous governance standards typically expected by the providers. In addition, as set out in our response to Q8, a smooth transition to IFRS is also necessary for a business that is considering a listing. A further illustration of this point concerns businesses considering a listing on one of the UK markets, which need to have established procedures that provide a reasonable basis for the directors to make proper judgments on an ongoing basis as to the company's financial position and prospects (FPP). (Under Additional Information, we have uploaded ICAEW's technical guidance TECH 14/14CFF which informs directors of about such procedures.)

For advisers, accelerators and fund managers:

31. The Commission could support development of a Europe-wide investor 'map' showing concentrations of investor types, for the purpose of improving cross-border connection of capital and businesses.

32. There are pockets of activity in the EU that put knowledge of concentration to good use and there may be ways to encourage such activity in regions where it does not currently exist. The need to encourage good companies to showcase themselves in cities where there is a high concentration of venture capital providers and angel investors is, for example, recognised by progressive regions and countries across Europe: the Finnish government and Scottish Enterprise both host annual showcases in London for investors to see some of their best tech businesses.

33. Another example of a pan-regional approach is the Fast Forward Pre Accelerator, supported by ERDF funding and the UK government, and works closely with accelerators across the UK. In addition, business accelerators such as Ignite (in Newcastle, UK), Dot Forge (in Sheffield, UK), Wise Guys (in Tallinn, Estonia) and Le Camping (in Paris, France) hold their demo days in London. One of Europe's oldest accelerators, Seedcamp, has for the past 8 years, been holding events in cities across Europe to find great early stage companies which they eventually take back to, in this case, London to showcase to investors.

For investors:

34. The Commission could urge Member States to explore practices in other countries where there are good examples of market-led mechanisms and networks that facilitate investor contact and engagement with businesses seeking funding.

35. Data from private equity suggest that proximity to investors does seem to matter to a company looking to secure investment. In the UK it is reported that the majority of all venture capital investments and a significantly large proportion of all angel investments are in businesses located in London - although there are also some signs that this is changing. Consequently, it has often been suggested that what is needed is to encourage or force investors based in London to 'hunt outside' London for great companies to invest in. In reality what happens is that entrepreneurs, particularly those seeking 'seed investments' go to London, or to Silicon Valley, to find investors. Even with signs of decentralisation of the location of investment, where investors have invested in businesses from outside their local eco-system, it is reported that in almost every occasion, the business has travelled to find investors (both within and outside the EU) and not the other way round. A business does need to be prepared, especially in the early days, to travel to investors and there could be a role for the Commission to coordinate contact channels and to target such efforts where evidence suggests that there is most need.

36. Such mechanisms are also relevant to public equity markets, particularly given the decline in intermediaries for smaller companies. There is support in the market for forums where companies can 'showcase' themselves to a range of potential investors leading up to an IPO. The Commission is well-placed to promote brokers' awareness of and ability to access businesses in other Member States (see also our response to Q11).

37. The Commission could additionally be instrumental in ensuring common standards of protection for retail investors and savers. 'Search for yield' investor behaviour is a key macro risk identified in the fifth Report on Risks and Vulnerabilities in the EU Financial System by the Joint Committee of the European Supervisory Authorities, and a framework is needed within which individuals can take responsibility for their investments. Such a framework could also accommodate new forms of investment and funding, so that innovation is provided with a ready space within which it can evolve.

Q6: Should measures be taken to promote greater liquidity in corporate bond markets, such as standardisation? If so, which measures are needed and can these be achieved by the market, or is regulatory action required?

38. Greater liquidity in bond markets across Europe is desirable. In our view, it is market-led efforts which respond to investor preferences, which will best serve liquidity in corporate bond markets.

39. Regulatory action might also not be a priority for the Commission as companies with tradable flows are likely to be at the larger end of SMEs. The outcome of any regulatory measures is thus unlikely to address the key CMU objective of improving access to finance for the small businesses in SMEs. We also note that here would be limited benefit for start-ups, given that term debt of this nature is typically a later stage form of finance.

Q7: Is any action by the EU needed to facilitate the development of standardised, transparent and accountable ESG (Environment, Social and Governance) investment, including green bonds, other than supporting the development of guidelines by the market

40. The Commission has had major positive impact in areas related to ESG, such as regional carbon trading initiatives and industrial permitting schemes. ESG investment has already been embraced by the private equity sector and it can become more widespread with the Commission's support, for example through promotion of ESG assessment of investments, especially in countries where this is not so developed.

41. The 'Green Bond Principles' were developed by relevant stakeholders - institutional investors, businesses and international finance institutions. The initiative remains 'live' and adapting market guidelines in the future, if considered necessary, will be easier than changing regulation. Thus, consistent with our reasoning on the need for cross border regulation of crowdfunding and peer to peer lending, we do not think that EU-level action is needed at this stage.

42. As the Commission rightly notes in the green paper, ESG investment is another source of potential finance. We think that there is certainly a role for the Commission to facilitate extending ESG investment principles to other areas including infrastructure, as identified in the Green Paper. Specifically, the Commission might consider how 'use of proceeds' principles might facilitate investment in:

- smaller businesses, eg perhaps through encouraging ESG disclosures in funding applications; and
- businesses with social (not just 'green') objectives, eg ones aligned with infrastructure.

43. Action at EU-level could also include research into ESG reporting by businesses, covering consistency, responsibilities and accountability as well as the effect on attracting investors.

Q8: Is there value in developing a common EU level accounting standard for small and medium-sized companies listed on MTFs? Should such a standard become a feature of SME Growth Markets? If so, under which conditions?

44. Small and medium-sized companies that raise capital through listing on unregulated markets need to provide high quality financial information to enable investors to assess their performance and prospects. Indeed, given that these companies, whatever their size, are taking money from the public, any debate about the appropriate financial reporting framework should focus first and foremost on investor protection, subject only to a careful assessment of cost: benefit considerations. It is in this context that we have considered the proposal to develop a common EU level accounting standard for such companies.

45. As a starting point, we strongly agree that it would be helpful for investors for a common standard or set of standards to be applied across relevant EU markets. The variety of GAAPs currently in use by such companies prevents comparability and adds to the challenges faced by investors seeking to understand the financial information provided by small and medium-sized companies listed in different EU jurisdictions. Thus, in principle, establishing a common standard or set of standards across the EU for small and medium-sized companies listed on unregulated markets should encourage investment.

46. Developing a new standard or set of standards is, however, unlikely to encourage investment from those that currently invest only in companies on EU regulated markets or where IFRS is the commonly used accounting framework. In our view, the preferred outcome of the current discussion would be a process of transition to IFRS for all listed SMEs. IFRS reporting is widely understood by investors (including from outside the EU) and it is generally accepted that, while not perfect, IFRS provides high quality financial information. It makes sense, moreover, for companies listing on growth markets with a view to graduating in due course to the main markets to use the standards applicable to those markets. Companies listed on the UK's AIM market are required to apply IFRS already, and at the very least the option to use IFRS by companies on growth markets should remain available.

47. We recognise that IFRS are complex standards and their application by listed SMEs can be challenging, not least in terms of the demanding disclosure regime. We think that the successful completion of the IASB's disclosure initiative could help significantly in this context; once its leasing and insurance standards have been completed, the IASB should be encouraged to make this project its primary focus.

48. There are of course alternatives to IFRS, but we do not think that any of them are more appropriate for listed companies, regardless of size or market. The IFRS for SMEs, for example, is one potential option. However, it is far simpler than IFRS – too simple for this purpose. This is because it has been developed for entities that do not raise money from the public and, for this reason, is unlikely to be appropriate for the type of entities being considered here. It also has some major differences from full IFRS.

49. Another approach, as proposed in the Green Paper, would be to develop a new common European standard. This approach is fraught with risks and more likely to be counter-productive. We envisage that any attempt to introduce a new European standard would engender disagreement and delays that would make an efficient process and the production of high quality, credible standard highly unlikely. We strongly discourage this course of action.

50. In any case, if an alternative standard to IFRS was selected, it would have to be aligned to IFRS in any case, to facilitate transition to full IFRS as companies grow and to minimise the effort required by investors (including from outside the EU) when familiarising themselves with a new set of requirements. Even so, it may be that investors would wish to reconcile the numbers with those that would have been derived from IFRS.

Q9: Are there barriers to the development of appropriately regulated crowdfunding or peer to peer platforms including on a cross border basis? If so, how should they be addressed?

51. It is the barriers to entering the lending market that lead to difficulties in regulating the non-bank sector. We thus consider below how some of the barriers might be overcome, in order to form a view on the impact on the Green Paper's aims of potential effective and sensible regulation.

52. One barrier is that a bank will have access to the SME's leading indicators for credit performance through their prime banking relationship. As their banker, they can see the firm's financial incomings and outgoings and being local can make an assessment of the business's sustainability in that local market. This information advantage places banks in a strong position and does not facilitate a competitive market.

53. Two solutions to this barrier: on the one hand, within the bounds of data protection, banks could be asked to share their customer data with a central counterparty that will have all inflow/outflow information on all relevant SMEs. It is important that this data set is detailed, covering not just arrears and accounts with poor credit performance but also who are the 'good payers'. Banks use application models initially but switch to a behavioural model after a few months because ongoing credit behaviour is more powerful in predicating default. If competitors are to emerge they will need provision of ongoing behavioural information (eg payment information through main bank). A central store is one mechanism by which the availability of credit information on SMEs could be improved so that it is easier for investors to invest in them.

54. On the other hand, credit reference agencies might also provide credit information on SMEs. If SMEs are externally rated this would help a private placement market for short-term finance.

55. Another barrier is that banks through their many years of lending experience have developed credit (and capital) models to assess credit quality. They have built robust credit decision making tools which other firms do not have. This again gives them a competitive advantage which limits the number of new entrants.

56. As a solution, banks could be required to share the design and parametrisation of their credit models. They could do this on an anonymised basis to protect them from customers 'gaming' their models. However, it is unclear (a) how banks would be compelled to do this, (b) how information might be spread to the market and (c) how information would be kept up to date. Unintended consequences of eroding banks' competitive advantage include loss of intellectual property and discouraging investment and innovation. Moreover, banks make changing commercial decisions depending on many factors and there will not be a standard SME lending model.

57. A further barrier is that potential investors may find it hard to make an assessment of their risk and downside losses, in light of differences in insolvency legislation (chiefly in creditor payment priorities) and practice in the EU. For example, on winding-up of the SME in a credit default scenario, creditors may be uncertain whether they have an enforceable legal charge over the SME's commercial property or whether there are legal hurdles to overcome, such as a long and expensive court process. Before agreeing to an SME loan, banks generally try to model three risk characteristics: probability of default, loss given default (LGD) and exposure at default. If they are not able to estimate one of these characteristics (LGD) because they do not fully appreciate the local insolvency regime, then they are not able to make an assessment of risk. This uncertainty about the loss given default may mean that they will not invest at all.

58. As stated in our response to Q29, we believe that the most effective way to overcome this would be to ensure that each Member State has a transparent insolvency regime which is readily accessible and enforced fairly and effectively. The EU could facilitate the necessary developments in those jurisdictions that do not already meet appropriate standards to improve transparency of insolvency regimes and creditor laws and encourage sharing of good practices. In addition, the EU Insolvency Regulation indicates clearly the insolvency law likely to be applicable, making it easier for potential investors to analyse the potential outcome.

59. Another barrier is that the new capital market could risk becoming one known for weak credit performance. If the capital market is populated by the SMEs that banks have declined then it may mean they are, by nature, higher risk. This would create an 'adverse selection' problem. If banks in using their advanced credit-decision making models and inside information (payment) related to the SME have decided the loan is too high risk, then the subsequent CMU's credit performance might be poor and the market would develop a reputation which would not attract high quality investors.

60. In response, good SMEs with strong access to bank finance should also be encouraged to take up good practices found in other capital market opportunities to help their credit performance, reputation and so develop the market's depth and liquidity. Moreover, to ensure the market is not open to abuse a supervisory entity might undertake background checks on the individuals running the SMEs for past insolvency or criminal behaviour.

61. The discussions on CMU provide a further opportunity to consider alternative finance in an open and supportive way. In its publication Crowdfunding Explained, the Commission recognises that there is space for alternative forms of finance to compete with traditional finance. The level of regulation that is appropriate for new forms of finance should first be assessed in Member States where they are sufficiently developed so as to facilitate effective scrutiny.

62. In the case of crowdfunding or peer to peer lending, cross border regulation may be premature. This is because even in Member States where such business models are more established, it is difficult enough to determine how sustainable the economic value of such funding is without also having to consider currency and regulatory risks and, to a lesser extent, bank charges for international transfers. As regulation at Member State level is in its infancy and/or still being refined, the cost of legal advice necessary for a business to be marketed on a cross border basis is also likely to be disproportionately high compared to the amount of capital to be raised. The Commission could encourage cooperation among those Member States where new investment and funding models are pioneered, for the purpose of developing minimum, common standards of best practice (such as for investor and consumer protection). Common standards can underpin regulation at national level and can also be applied to future models.

Measures to develop and integrate capital markets - Developing and diversifying the supply of funding - Boosting institutional investment

Q10: What policy measures could incentivise institutional investors to raise and invest larger amounts and in a broader range of assets, in particular long-term projects, SMEs and innovative and high growth start-ups?

63. The Commission could conduct a pan-European review of the extent of national restrictions on the allocation of institutional investors into certain asset classes. This may help provide grounds for possible interventions at national level.

Q11: What steps could be taken to reduce the costs to fund managers of setting up and marketing funds across the EU? What barriers are there to funds benefiting from economies of scale?

64. A precursor to enabling a cross-border market in Europe would involve helping to develop the markets in individual Member States. How individual markets operate and their risks need to be understandable and clear in order to attract an investor base. Corporate finance professionals report that investors are cautious and relatively rarely stray out of their domestic boundaries. The less familiar investors are with the economic or political infrastructure of a country, the less likely they are to risk investing in it, even if they are aware of businesses in that country that are seeking capital. In turn, fund managers need to be convinced that there is a deep enough pool of capital across or within specific Member States, so as to consider setting up and marketing funds there.

65. The Commission can also encourage the right environment to develop for building relationships. Compared to equity markets, the private equity sector has relatively well-established relationship and distribution networks – albeit, mostly within individual Member States. This is evident even in Member States with more developed public markets. In the UK for example, brokers are not set up to know about investors across Member States. The Commission can play a significant role in disseminating good practices to help develop such networks.

66. The Commission could usefully prioritise a detailed impact assessment of the AIFMD regime as this would yield important information on the extent of registrations and highlight specific steps that could be taken to reduce the costs to fund managers. Reports suggest that some fund managers have found that host regulators have asked them for additional fees and more documentation. This could be a barrier to managers' efforts to scale up efficiently and across multiple Member States.

Q12: Should work on the tailored treatment of infrastructure investments target certain clearly identifiable sub-classes of assets?

67. We have no comments.

Q12.1: If so, which of these should the Commission prioritise in future reviews of the prudential rules such as CRDIV/CRR and Solvency II?

68. We have no comments.

Q13: Would the introduction of a standardised product, or removing the existing obstacles to cross-border access, strengthen the single market in pension provision?

69. This generally seems to be a sensible proposition and one consistent with freedom of movement. However, we struggle to see how it can be achieved at a practical level. In essence a pension product is a tax wrapper that complies with the specific legislation of the jurisdiction in which the pension product is sold. The concept of a standard pension product and even the notion of a 'portable' pension product would, therefore, require the harmonisation of other regimes across jurisdictions. We do not necessarily believe this is either desirable or practical as the Green Paper already recognises that further analysis and feedback is needed to identify the scale of the challenge in areas such as tax, and the appropriate solutions and degree of prioritisation.

70. An approach that could yield quicker results would be to draw on existing experience. At the same time, more detailed research could be undertaken to identify what encourages people to save into pensions and to ascertain demand for a standardised product. This research needs to include an analysis of the types of pension products that are available in different jurisdictions to establish which product features different types of consumer value, to help frame appropriate policy at Member State level. The emphasis needs to be on simplicity and stability: complicated and ever-changing regulatory and /or government policy in the area of pensions leads to disengagement and a lack of consumer trust and adds to costs, which can only be counterproductive at all levels.

Q14: Would changes to the EuVECA and EuSEF Regulations make it easier for larger EU fund managers to run these types of funds?

71. Anecdotal evidence suggests that it is the restricted investor categories to which they can be marketed, together with the minimum investment commitment, that limit the attraction of EuVECA funds. For example, in the UK, Enterprise Investment Schemes (EIS) enable investment in small, unquoted companies. However, as most EIS investors are UK-based, having an EU marketing passport is not critical to EIS managers and few have felt the need to register as a EuVECA manager.

72. An impact assessment of AIFMD and EuVECA regimes would reveal potential changes to these regulations that might encourage larger fund managers to run such funds.

Q14.1: What other changes if any should be made to increase the number of these types of fund?

73. We have no further comments.

Q15: How can the EU further develop private equity and venture capital as an alternative source of finance for the economy?

74. As part of an impact review of the AIFM Directive, the Commission should consider the need for extending the third country equivalence regime, which could benefit choice.

75. At Member State level, policy measures such as tax-advantaged venture capital schemes have been effective in boosting investment and the Commission can aim to minimise uncertainty in the State Aid approval process.

Q15.1: In particular, what measures could boost the scale of venture capital funds and enhance the exit opportunities for venture capital investors?

76. We have no further comment.

Q16: Are there impediments to increasing both bank and non-bank direct lending safely to companies that need finance?

77. We see the principal impediments as being:

- funding SMEs and high growth start-ups is a risk reward problem and SME lending is inherently high risk; and
- the challenges faced by those responsible for balancing competing public policy objectives.

78. For example, compared to residential mortgage lending where there is always collateral to cover the full amount of the loan and the creditor has a strong interest in keeping their home, the credit performance of SME lending is poor. As a consequence of this, national (and international, namely Basel) financial services regulators ask deposit-taking institutions to hold larger capital reserves for the likely losses of SME lending. One interpretation of asking banks to hold proportionately greater capital resources for the greater risk of SME lending is that it may be misinterpreted as regulatory requirements being punitive to SME lending. We do not agree with this view as we think it is a natural consequence of the risk profile of SME creditors and the sound financial balance sheets we wish banks to maintain.

79. A financial services regulator will typically have legally defined objectives which focus on the safety and soundness of the financial system. These may compete with the economic rationale for promoting the flow of capital. National regulators could be asked to relax their regulatory capital requirements to support economic policy, notwithstanding that this is not typically consistent with the regulatory objectives. Individual countries have adopted (albeit short-term) solutions where regulatory capital requirements have been relaxed to support lending to the real economy. For example, under the UK's Funding for Lending Scheme, increased net lending by banks attracted zero additional capital.

Measures to develop and integrate capital markets - Developing and diversifying the supply of funding - Boosting retail investment

Q17: How can cross border retail participation in UCITS be increased?

80. UCITS are a good standardised product, specifically designed for retail investors and, in many Member States, there are already many funds that investors can choose from and that invest monies across different jurisdictions and across different asset classes. We do not believe that greater cross border participation is the key issue. Investors can be overwhelmed with choice and we believe that the majority retail investors need access to low-cost, straightforward investment products and that the market is generally well served in this area. As mentioned in our responses to Q20 and, in Q9, in relation to alternative forms of investment and funding, we would support efforts by the Commission to promote a framework of common minimum standards for retail investment.

Q18: How can the ESAs further contribute to ensuring consumer and investor protection?

81. Efforts to put European savings to better use must treat retail and other investment appropriately. In particular, the objectives of encouraging retail investment and widening the investor base for SMEs should not be conflated. It is not generally appropriate for retail savers to be steered towards investments that are inherently high risk (eg SMEs and long term projects) as they have lower opportunities for diversification.

82. Far more emphasis is needed to raise the level of financial literacy across all jurisdictions. Since 2014, financial literacy education is statutory in England and the mathematics curriculum is intended to ensure that young people leave school with an understanding of the skills needed for personal finance. This is another area where the Commission can encourage sharing of national practices and support more detailed research into what drives consumer behaviour across different jurisdictions.

Q19: What policy measures could increase retail investment?

83. We believe market forces and straightforward and transparent consumer protections are the main drivers here, in conjunction with tax regimes that encourage retail investors to commit to long term saving vehicles that are appropriate to their needs. Stability and consistency of regulatory and fiscal policies are key ingredients for winning the confidence of retail and professional investors alike. To illustrate, we point to the UK's tax-efficient individual savings account (ISA), where continued government support and favourable tax status have contributed to this product becoming a mainstream retail investment.

Q19.1: What else could be done to empower and protect EU citizens accessing capital markets?

84. In addition to raising the level of financial literacy, EU citizens need reliable and objective guidance to help them manage their personal finances. They also need to be able to access professional objective advice at an affordable cost. Keeping financial products simple and regulation stable are the best ways of addressing the first point and where the Commission could have impact. The second point is more challenging; possible solutions such as a national advice scheme or a degree of tax deductibility for advice all carry cost implications.

Q20: Are there national best practices in the development of simple and transparent investment products for consumers which can be shared?

85. We support the idea of sharing best practices among Member States. For example, successful initiatives in the UK are, in the area of retail investments, stocks and shares individual savings accounts which have continued to attract the long-term support from retail investors. Stakeholder pensions and auto-enrolment pensions are other initiatives that have helped encourage consumers to save more for their retirement. Examples in more specialist areas include venture capital trusts and enterprise investment schemes, which offer tax incentives to encourage high net worth and sophisticated investors to invest in early stage and small companies.

86. The Commission might consider promoting common minimum standards that encourage retail investment and empower and protect consumers and investors. Standards would comprise financial literacy and education of citizens, existence of objective channels of information, availability of affordable professional advice and appropriate products.

Measures to develop and integrate capital markets - Attracting international investment

Q21: Are there additional actions in the field of financial services regulation that could be taken to ensure that the EU is internationally competitive and an attractive place in which to invest?

87. There should be a determined effort to simplify and make such regulation easy to understand and to conduct cost/benefit work to ensure proportionality.

88. Any measures introduced with the stated objective of harmonising regulation of capital markets should not also be anti-competitive for individual Member States.

Q22: What measures can be taken to facilitate the access of EU firms to investors and capital markets in third countries?

89. We have no comment on specific measures but agree that conditions under CMU need to be right for providers of capital from outside the EU.

Improving market effectiveness – intermediaries, infrastructures and the broader legal framework

Q23: Are there mechanisms to improve the functioning and efficiency of markets not covered in this paper, particularly in the areas of equity and bond market functioning and liquidity?

90. We have no comment.

Q24: In your view, are there areas where the single rulebook remains insufficiently developed?

91. We have no comment.

Q25: Do you think that the powers of the ESAs to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a Capital Markets Union?

92. We have no comment.

Q26: Taking into account past experience, are there targeted changes to securities ownership rules that could contribute to more integrated capital markets within the EU?

93. We have no comment.

Q27: What measures could be taken to improve the cross-border flow of collateral?

94. We have no comment.

Q27.1: Taking into account past experience, are there targeted changes to securities ownership rules that could contribute to more integrated capital markets within the EU?

95. We have no comment.

Q28: What are the main obstacles to integrated capital markets arising from company law, including corporate governance? Are there targeted measures which could contribute to overcoming them?

96. We believe that there are few issues where EU initiatives and further harmonisation are necessary. In our view, therefore, the capital markets project should concentrate on identifying which jurisdictions have proven attractive regimes for capital markets and the extent to which their company law framework (for instance) contributes to this with a view to encouraging those with less developed markets to choose to amend their national laws as may be appropriate.

97. There is, of course, already a degree of harmonisation in company law and related areas (such as the Prospectus Directive). It is moreover, in principle, open to businesses from one Member State to incorporate in another and for the relevant company to conduct business throughout the EU. There may be practical difficulties for a business in doing this, for instance, use of a foreign language or difficulties in establishing branches (or establishments) in particular Member States, and this is something that the Commission could address.

98. We would also welcome action to make it easier for companies to demerge on a cross-border basis, although we doubt that this would have a material impact on capital markets' efficiency in the EU, as there are ways in which businesses can overcome the difficulties that might otherwise arise.

99. In terms of specific company law issues mentioned in the consultation, the UK has the largest capital markets in the EU and appears to have well developed national law to facilitate this. In particular, UK standards in the following areas may provide useful comparisons:

- minority shareholder rights (highly developed protections, including under common law);
- a long tradition of high standards of best practice in corporate governance for listed companies (eg as 'softly' codified in recent decades in the UK Corporate Governance Code); and
- clear requirements of company directors (Companies Act 2006), aligned to corporate governance requirements for listed companies.

100. It is important that efforts to improve the efficiency of capital markets in the EU are not focused on the objective of harmonisation for the sake of it. The Green Paper sets out areas that should rightly be subject to separate initiatives (if harmonisation in those areas is to be pursued at all), such as taxation and employment and contract law and rights of security. This approach will avoid the risk that countries whose capital markets function well might be adversely affected by harmonisation efforts directed at those countries with less well developed capital markets, where it is open to those countries to address any underlying weaknesses themselves.

Q29: What specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European capital market?

101. We are of the view that encouraging transparency of insolvency regimes and creditor laws would go a long way towards addressing the challenges of variation in insolvency regimes. It is important that the insolvency laws of each jurisdiction are clear and that sufficient information is made available for them to be understood by potential investors. Relevant information would include priorities of creditors, rates of recovery, the length of time taken for recovery and the costs of insolvency processes in respect of each insolvency procedure. The impact of different practices on investment might then be more easily assessed.

102. Harmonisation, on the other hand, would be much more challenging to achieve and potentially counterproductive (depending upon what is required to change as a result). There are widely divergent regimes throughout the EU and the differences relate not only to the statutory framework of both national and EU law but to the wider infrastructure, including whether or not the courts have appropriate skills, experience and resource and whether or not the country has a sufficiently large pool of experienced professionals to advise business. It should be noted that insolvency law draws on, inter alia, corporate, trust, employment, pensions, health and safety, financial services, banking, and securities laws, each of which are different in different Member States.

103. Insolvency law is also very closely linked with individual Member State's views on social and business policies. Merely harmonising elements of insolvency law may run counter to other aspects of legislation in Member States and, in addition, may not result in harmonised outcomes in a way that would increase certainty for those considering investing in businesses. If harmonisation were to require a Member State with a relatively 'pro creditor' regime to reduce creditor protection, it might be expected to reduce, rather than increase, investment (or increase the cost of investment).

Q30: What barriers are there around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level and through which instruments?

104. Global changes to the tax systems of all the EU member states can only be made if all the Member States are in agreement. This is the unanimity principle and tax is one of the very few remaining areas of EU policy making where this principle has been retained.

105. Each Member State has sovereignty over its own tax system. If, for instance, each Member State has its own headline rate of tax on corporate profits then this is going to encourage business to operate in some countries rather than others. And this could be for tax rather than economic and commercial reasons.

106. At the EU level there has for the past 15+ years been a Code of Conduct group to ensure that no Member State is unreasonable in the domestic measures it introduces to compete against other Member States. As announced in March, the Code of Conduct on Business Taxation is being reviewed to take into account more sophisticated corporate tax regimes. As part of this review, we believe that the functioning of the group should also be addressed to ensure greater transparency about its activities, thereby restoring greater confidence about the effectiveness of its work.

107. At the moment there is a muddle between competition and cooperation in the EU tax system. The Commission is attempting to introduce some rigour to the system through its Tackling Tax Evasion and Tax Fraud programme, announced in December 2012, the more recent Tax Transparency Package (March 2015) and the expected Action Plan (due in late spring/early summer).

108. What business needs, and what a properly functioning capital market also needs, is some continuity and certainty. And a clearer vision as to what the particular tax system is seeking to achieve.

109. We understand that in the next months, as part of the Action Plan, the Commission will relaunch its Common Consolidated Corporate Tax Base (CCCTB) project but it is unclear as yet what approach will be taken.

110. In addition to certainty, multinational businesses operating in a number of different EU countries need to have a system which allows them to get relief for genuine losses in one country against the profits that they make in other countries so that only the aggregate group profit is subject to tax. Appropriate safeguards will be necessary so that a system is not open to manipulation.

111. The OECD is currently working on a major recalibration of the international tax regime and the Commission needs to fit its own plans to that other Agenda which is being controlled by the G20. There needs to be joined up decision making, not only between countries, but also between international organisations, including the European Union, OECD and also the UN which has some influence in international taxation issues.

Do financial institutions pay their fair amount of tax?

112. There have been suggestions that the answer to that question is no and the proposal to introduce a Financial Transactions Tax (FTT) under the enhanced co-operation procedure is a suggested solution to that problem. We believe that there needs to be a more robust analysis of the contribution that the financial services sector makes to the public finances of the Member States of the EU. (A view from the UK on this issue is being uploaded under Additional Information, as part of this response.)

Q31: How can the EU best support the development by the market of new technologies and business models, to the benefit of integrated and efficient capital markets?

113. New ideas should be given the space to be tested and regulation before the product and its possible problems are clear should be avoided.

Q32: Are there other issues, not identified in this Green Paper, which in your view require action to achieve a Capital Markets Union? If so, what are they and what form could such action take?

114. We have no comment.

Additional information

Should you wish to provide additional information (e.g. a position paper, report) or raise specific points not covered by the questionnaire, you can upload your additional document(s) here:

Documents uploaded with online answer:

ICAEW publication, Europe's future in global markets
The Business Finance Guide (Q5)
TECH 14/14CFF Guidance on financial position and prospects procedures (Q5)
Extract from Taxing Banks Fairly (chapter by Ian Young, ICAEW) (Q30)

APPENDIX

Corporate Finance Faculty
Recognised internationally as a source of expertise on corporate finance issues and for its monthly *Corporate Financier* magazine, the Faculty is responsible for ICAEW policy on corporate finance issues including submissions to consultations. The Faculty's membership is drawn from professional services groups, advisory firms, companies, banks, private equity, law firms, consultants, academics and brokers.

Financial Reporting Faculty
Recognised internationally as a leading authority on financial reporting, the Faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The Faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

Financial Services Faculty
As a leading centre for thought leadership on financial services, the Faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk management, auditing and reporting issues facing the financial services sector. The Faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services.

Tax Faculty
Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world.

Finance and Management Faculty
The Faculty is recognised internationally as a source of expertise on financial management issues and for its monthly *Finance and Management* magazine. Members include CEOs, CFOs, Financial Controllers and a broad range of finance professionals in business. The Faculty is responsible for ICAEW policy on financial management issues including submissions to consultations

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

Corporate Governance Committee
The Committee's members are drawn from the business and investment communities. The Committee informs our thought leadership and policy work on corporate governance issues and related submissions to regulators and other external bodies.

Sustainability Committee
ICAEW seeks to analyse and address fundamental issues and questions surrounding sustainability as one of the biggest challenges facing society today. Our *Sustainable Business* thought leadership programme explores how organisations and markets are motivated to deliver sustainable outcomes and the role of information flows in this. We aim to be at the forefront of thinking and action in sustainability, focusing on systems-level change which recognises the interconnected nature of the world we live in.

Insolvency Committee
This is a technical committee made up of Insolvency Practitioners working in large, medium and small practices. The Committee represents the views of ICAEW licence holders.