BÜNDNIS 90/DIE GRÜNEN Bundesarbeitsgemeinschaft (BAG) Wirtschaft und Finanzen Response to the European Commission Green Paper on a Capital Markets Union

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BAG Wirtschaft und Finanzen is the highest committee dedicated to economic and financial policy within the German Green Party (BÜNDNIS 90/DIE GRÜNEN). It consists of two elected delegates of each federate state (Bundesland) and of several Green Party affiliated Members of State, Federal and European Parliaments.

Introduction

The BAG acknowledges the primordial importance of a well-functioning financial system for consumers' sake, for tax payers' sake (get rid of implicit public subsidies and risk of public bail-outs) and for promoting sustainable investments. BAG is in favour of an overhaul of the currently too complex system of regulation. Rules should be simpler but much stricter at the same time (e.g. much more equity capital for banks).

We clearly welcome the principle of open and integrated capital markets in the EU. The disintegration of our European capital and banking markets after the Eurozone crisis is not in the interest of our European economies and citizens.

It would be great, if the Commission could use this CMU initiative to reconcile some of our core European values with financial markets in Europe. Mainly, long term financing of sustainable investments, economically, ecologically and socially sustainable, should be promoted. Some of the ideas in the Green Paper fostering higher quality information on sustainable investments are therefore very welcome.

The Commission's ideas on promoting consumers' interests are highly welcome as well. Particularly the idea of promoting standardized products for private pension savings could be very interesting, both in a sense of offering consumers better products and for the economy by investing long term pension savings into the real economy instead of government bonds.

Also the idea of harmonizing capital markets regulation within the EU is very good, particularly if it goes hand in hand with a strengthening of the European supervisory system, like EIOPA and ESMA.

Finally having a capital markets union to offer wider access to equity capital for midsized and for young and fast growing companies is most important. Young and dynamic SMEs clearly lack access to equity financing.

When reading the Green Paper and the suggested initiatives, it is not clear however, if really the most important impediments to these goals are being addressed or if rather the main goal of the Commission is to encourage non-bank lending. If that were the case, the very good idea of a CMU may be compromised, especially if the idea is to deregulate banking and non-bank lending. Non-bank lending is just a nicer word for shadow banking. The CMU could thus be just a politically astute way of promoting deregulation. Then it should be condemned.

We would also strongly warn against a misled believe that a CMU might be the panacea to promote growth in Europe. When looking at studies on the advantages of a market based versus a bank based system, there is overwhelming empirical evidence that none of the two systems is superior in promoting growth (cf. Ross Levine (2002), bank-based or market-based financial systems, which is better?). Also, when asking the questions if market-based systems recover faster from a recession, the first impression is that they do recover faster, however, empirically the main driver does not seem to be the financial system but rather more flexible product and labour markets in these economies (Julian Allard and Rodolphe Blavy (2011), Market Phoenixes and Banking Ducks – Are recoveries faster in market-based systems?).

In the current political debate many people quote the impressive recovery of the USA after the financial crisis and attribute this to its market-based system. However, much more important for the recovery of the US have been its much more decisive fiscal and monetary policy and the massive forced recapitalization of its banks. If the Commission really wants to promote growth they should tackle the two elephants in the room: stop austerity and recapitalize the banks.

This does not mean that promoting capital markets is useless. Many countries in Europe have a debt based financial system. Young and dynamic companies, however, do not need access to more debt, they need equity financing. Long term growth projects, especially with young and small companies should be financed via equity. The issue is not if companies take on debt via banks or via capital markets, the question is if companies have access to equity financing.

We also think it is highly important to acknowledge that SMEs are not the right target group for capital markets. They cannot afford the sophistication in their reporting systems and their capital markets communication. The initial cost of going public is too high. It will not be possible to finance equity analysis or credit rating for so many small companies. When they go public with a bond or with shares, their market capitalization will be so small that there will be no liquidity. Institutional investors need to write tickets of many millions. If the company is a true SME these investors would control too big a stake in that company. Only midsized companies with sales of several hundred million Euros should access capital markets also in a well functioning CMU. This is why also in the USA banks and not capital markets finance SMEs.

It is also important to note that debt financing via capital markets is highly inflexible in times of crisis. SME and especially young and fast growing companies have a much less stable business model than a decades old large company. Their investment projects are much more risky. It may take longer than expected to develop a new product or unlock a new market. The cash flows to service the debt may not be sufficient due to these time delays. Relationship banking allows to renegotiate the terms of the debt. This is not possible with capital markets financing. Capital markets debt financing therefore is much more risky for small and growing companies.

However, of course, relationship based financial intermediaries like venture capital or growth oriented private equity funds may invest in growth oriented SMEs. This should be encouraged! And classical SMEs who do not intend to finance very fast growth are best served with a good and well capitalized relationship based banking system.

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

We think the Commission does not choose the best priorities and therefore tries to cure some symptoms instead of attacking the root causes. We would recommend to analyze the differences within Europe. You are only showing aggregate numbers in your paper. However, the differences among the member states are huge. Some of them have highly active capital markets others not at all. In our view, the differences between Germany and Sweden are particularly telling. These two countries have very similar social norms and business culture. Nevertheless, the differences regarding capital markets between them are striking:

Look at the equity culture in Sweden compared to Germany and the rest of Europe, i.e. the market capitalisation of the stock market compared to GDP, the percentage of domestic investors in stock listed companies, the easiness of doing IPOs in Sweden, the VC culture, the number of start-ups, the success of start-ups, the amount of VC invested in relation to GDP, private equity invested in relation to GDP, market share of local PE firms compared to US&UK firms, you will see that Sweden is the opposite to Germany and certainly at the top of the EU.

1. Pension reform

In our view the single most important driver for these differences is the pension system:
The Swedish state pensions have a large capital buffer (the AP Funds). These funds have very sizeable public and private equity allocations. On top, private pension savings are channelled through an opt-out mechanism into the AP7 Fund, which allocates 100% into equities until the individual saver reaches the age of 55, then it gradually reduces the equity ratio to 33%.

The EU could offer an EU wide AP7 fund into which citizens can invest on a voluntary basis. And the EU could push the member states to have larger buffers within their state pensions. These buffers should be invested into equities. If capital markets, private equity and venture capital in the EU were like in Sweden, we would not need a CMU initiative. Let us take the most important feature for Sweden's success and bring it to Europe.

If this is not possible, the next best solution is to reform private pensions in Germany and probably many other member states. Most of retirement savings in Germany are channelled through life insurance companies. These companies invest only 3% of their assets into equities despite the fact that they should have extremely patient long term capital. The reason for their absurdly low allocation to public and private equity is not current regulation (Anlageverordnung, nor coming Solvency II). The German Anlageverordnung would have allowed an exposure of 35% to equities.

The life insurance companies cannot use this regulatory headroom because of the dysfunctional guaranteed returns they promise. These returns are guaranteed on a yearly basis and the customer can cancel her contract at any time without cancelation fees. This makes German life insurance the opposite of long term investing. The combination of a guaranteed return combined with the cancelation option obliges German life insurance companies to invest into highly liquid non-volatile assets. This is further aggravated by the extremely thin layer of shareholders' equity (<1.5% on average). If there were a decline in the value of assets (for instance due to a severe and sudden rise of interest rates) this system is prone to a panic and run.

The solution to this problem must not be to become more lenient on Solvency II but rather to radically reform the system of guarantees. They must not be a combination of an almost costless immediate cancelation option combined with a guaranteed value. The insurers might promise a guaranteed pension once the customer has reached pension age but not a guaruanteed value at cancelation of the policy. And to issue such guarantees the insurers need massively higher shareholders' equity.

If the EU does not want to offer a state managed pension fund like AP7 in Sweden, it should force private life insurance companies to offer a standardized product with very high equity exposure and very low fees, sold on an EU wide internet platform without any sales provisions.

2. Harmonize accounting rules, corporate taxation and insolvency rules

Accessibility of higher quality information about SMEs both in economic terms and also on their ESG standards is one of the more important issues to promote a CMU. This should clearly be taken seriously and taken many steps further than those suggested in the Green Paper (see the answers to the questions below for more details). Most important in this endeavour, however, is a standardization of accounting and reporting rules (cf. question 8).

Today it is also difficult to judge the true level of profitability of a European SME because the tax rules are so different in every company (cf. question 8). Capital will only flow into the real economy, especially across borders, if there is good information and if there is trust.

3. Investigate the UCITs market in the EU and introduce more competition

How come that in Germany all mutual funds have the same fee structure? All charge 5% sales commission, all have about 1.5% management fee and all have the same performance fee. Why does this need to be so much more expensive than in the US? In the US, there are no entry commissions and yearly fees are clearly below 1% and the performance fee is symmetric. Could it be that there is an oligopoly of four vendors in Germany? You cannot foster an equity culture if funds are absurdly expensive.

4. Explore debt instruments with equity character

Many authors have recently stressed the systemic problems of a debt based economy. Acknowledging that full equity is not always possible they have recommended debt instruments with equity character, like e.g. mortgage loans which fluctuate with the value of the underlying real estate, or GDP linked sovereign bonds or corporate lending where the debt service is linked to the profitability of the company (cf. Robert Shiller (2012) Finance and the Good Society; Martin Hellwig (2013) The Banker's new Clothes; Martin Wolf (2014) The Shifts and the Shocks, Main and Sufi (2014) House of Debt). Such contracts would be countercyclical and significantly enhance systemic stability.

5. Promotion of classical local banks

A network of strong local banks, well capitalized and deeply entrenched in their local communities is the best way of fostering lending to PMEs. These banks do not need subsidies. However, they have a disadvantage against large banks that do enjoy huge (implicit) public subsidies due to their TBTF status. These small local banks also cannot cope with the enormous complexity of current regulation. The conclusion, however, should not be a second set of regulation lite for small banks rather an overhaul of the too complex current regulation. Make simpler but much stricter rules, like e.g. imposing far more equity capital. Go to the core of the problem, have a strict rule for the core and do not introduce hundreds of rules for the fringes because you do not dare attack the core.

6. No securitisation

We do not think that securitisation is the right priority. The securitisation model has an inherent conflict of interest that has not been solved. If the originator does not need to keep the risk he will always be negligent, contract too risky credits and sell them on. The fees for origination by far outweigh the risk of the small skin in the game. We do not see how the selection of the securitised credit can be made in a way that the bank does not keep 100% of its good loans and sell 95% of its non-performing loans. The information asymmetry is too big. There is no evidence, not even in the US that securitisation of SME credit works. SME credit is too diverse and intransparent to be a good base for securitisation. There is no way to offer securitisation for small institutional investors without relying on rating agencies because small investors cannot analyse the securities.

In a normal credit relationship between a SME and a bank, the SME can renegotiate terms of the credit if there is a temporary problem. The bank, knowing its client will usually rather consent to new terms than drive the customer into insolvency. We do not see how this flexibility can be upheld in a securitisation model. The SME must therefore be asked to consent to securitisation. If not, the SME is paying the high price of a loan because it thinks it will have the flexibility of a normal loan but instead it has all the inflexibility of capital markets lending without getting the lower price.

Securitisation will not foster an equity culture in Europe and will not open alternative financing to SMEs and to growth oriented midsized companies. And it is dangerous. It is clearly the wrong priority. If banks really need further funding, the EU should investigate if the German covered bonds system is not clearly preferable to the US style securitisation model.

2. 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?

Providing standardized information and analysis is most important for capital markets. The individual investor usually does not have the means to analyse the companies he wants to invest in. Today, you find credit information provided by rating agencies and equity analysis provided by the investment banks. However, this information is clearly underprovided because it is a classical public good. It is impossible to make the users pay for it because you cannot really keep it secret. And smaller investors, let alone retail investors could not afford to individually pay for such reports. You therefore only find analysis on the very large companies. The fact that there is no decent information available on midsized companies is one of the severe obstacles to a functioning capital market for midsized companies, let alone for SMEs. A reform of credit AND equity analysis is therefore of high importance. Since it is a public good, it should be publicly funded. The issuers of debt or equity must not fund it because this creates very skewed incentives and has led to e.g. AAA ratings of subprime mortgages.

The easiest way would be to introduce a very small levy on each purchase of a security from the investors. This levy could be used to pay for analytical reports of all companies that issue bonds or public equity. In order to have competition between the different analysts and rating agencies, one could pay a very modest base fee for these services and a very generous success fee. The rating agencies or analyst companies having made the most accurate analysis over a mid-term period (e.g. three years) will get this large success fee. These analytical reports could be publicly accessible without any further fees.

Recognizing that decent credit and equity information is a public good and therefore not provided by private markets is one of the most important insights of this Green Paper. Public funding of private rating agencies and equity analysts is essential. Performance based pay will foster competition and high quality work.

7. 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?

Good information on companies is very difficult to obtain (cf. question 2). Individual investors typically do not have the means for such analysis. It is most important to enhance trust through reliable information. Many investors care for other things than just financial information. ESG is an important investment criterion for many. Therefore one definitively needs reliable standardized information on ESG. It will significantly enhance trust. It could be financed like the credit information in question 2. Getting our core European values in sync with our financial markets is a most important issue.

8. 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?

One of the most important issues why there is no capital market for SMEs is that there is no information on SMEs. Therefore question 2 is so important. However, even the work of credit rating agencies will be significantly easier if the accounting standards of SMEs across Europe were the same. If profits vary only because of different accounting standards, investors will never trust to invest into SMEs outside their home country. We need something better than current IFRS for SMEs. However, it must be the same standard across all Europe. And it must be made sure that SMEs need to use only this common standard for reporting and no additional national ones. It must also be watched out that these common accounting rules do not have different national interpretations like e.g. IFRS in Italy.

Also the EU wide corporate tax regime must be harmonized. This would facilitate a common accounting standard. Today, profitability of comparable companies in different countries is not comparable due to different tax rules. Harmonizing corporate taxation and bringing national SMEs on a level playing field with multinationals who can game the system is one of the highest priorities.

9. 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?

If crowdfunding refers to an internet platform that is nothing but a technical matching between SMEs and individual investors in a sense like a stock market, then how should the individual investors select the companies they want to lend to? Do they have the capacity to analyse them and make good credit decisions? Can they monitor the credits and take action if covenants are breached? It is hard to imagine how such a model could work.

Or are the crowdfunding companies more active? Do they do the analysis, make a preselection, negotiate the credit terms, monitor the credits and take action if covenants are breached? Such a model could work, but then the crowdfunding platform is in principle an online bank and needs to be regulated accordingly. It should have skin in the game and there must not be conflict of interest. The crowdfunding firm should not get fees from both sides (borrower and lender). It should have a lot of skin in the game (that is plenty of equity which it can lose) and make money only if the investors make money in the long term (i.e. introduce some sort of carried interest payable earliest after five years). If there continues to be maturity transformation, i.e. if the investors can retire their money before the credit has been fully paid back, then the regulation needs to be even stricter and then crowdfunding is a bank.

10. 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?

There are no incentives needed, only reform the guarantees for life insurance in Germany. We think it is illusionary that institutional investors will invest directly into projects and into SMEs or high growth start-ups. They won't have the capacity to select these projects or companies. The only way to make such institutional investors invest more money into infrastructure and especially into SMEs and high growth young companies is via specialised Infrastructure and VC or growth oriented PE funds. However, this is not a problem. As soon as institutional investors significantly increase their allocation to alternative assets they will invest into such funds.

The EU could promote cooperation between pension funds and life insurance companies. Many of them are too small to build an alternative assets team. They do not have the know-how to select the right VC funds or PE funds. If pension funds cooperate to fund joint teams this should not be seen as an anti-trust issue.

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

There are no incentives needed. Please *do not* use the slogan of CMU to start deregulating banks and insurance companies again. As long as banks and insurance companies have so little equity capital they need tough regulation. As long as German insurance companies operate like a CNAV money market fund and promise constant value and immediate redemption, and as long as they have basically no shareholder equity (<1.5%), Solvency II must get stricter and not more lenient.

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

Yes, very much so. One needs a very easy, standardized product with basically no fees passively investing into private and public equity, like the AP7 fund in Sweden (cf. question 1).

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

Reform of private pension savings (see question 1) and reform the current system of guarantees. Thus make sure that private pension savings can be invested in equity products. Then PE and VC will come by itself.

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

As soon as institutional investors can have a much higher allocation to VC private equity, there will be no more exit problems because business angels will sell to seed investors who will sell to VC, who will sell to growth funds who will sell to PE and who will IPO (cf. question 10). Direct IPO of small and young high growth companies is not advisable.

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

Bank lending does not work because banks have too little equity. The EU should promote small community banks that finance the real economy.

19. What policy measures could increase retail investment?

- Enhance competition so that too high fees get reduced
- Introduce standardized low fee funds investing into equities (like AP7, cf. question 1)
- Introduce opt out model for private pension savings into such standardized equity fund.

It is not clear, however, that it is beneficial for the economy if retail investors empty their bank accounts and invest them in capital markets. Banks have a very strong role to play for the financing of SMEs and it is preferable if banks finance themselves with retail deposits instead of volatile wholesale funding.

The only question is if retail savings need to be in deposits where they can be withdrawn instantaneously. Even if they are less prone to panic and run than wholesale investors, this type of funding still is short term. Therefor the Commission should promote retail savings bank accounts that offer the same type of protection as any other deposit guarantee but that are much more long term.

If banks offer more hybrid financing instruments like mortgages linked to the value of the underlying real estate (cf. question 1), one should investigate how retail saving accounts could match these hybrid financing instruments, i.e. how the to make retail saving accounts more long term and how to have them bear some of the risk and participate in the upside of such hybrid financing instruments.

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

Yes, the Swedish private pension system (the AP Funds, especially AP7).

28. 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?

Yes, investors should have more say on the composition of boards. Today in many countries non-executive board members are co-opted by management and current non-executive board. They should be selected and nominated directly by the shareholders. Only shareholders with a long term perspective should have the right to vote.

30. 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?

Get rid of tax subsidy for debt. Abolish the possibility of offsetting interest expenses against taxable profits. This reform does not need to lead to higher tax revenues. The higher revenues due to the abolishing of the interest expense tax shield could be used to lower the corporate tax rate.