DEUTSCHE BUNDESBANK
EUROSYSTEM

Deutsche Bundesbank's reply to the European Commission's Green Paper "Building a Capital Markets Union"

Answers to specific questions

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

We agree with the Commission that the five areas it identified for short-term priorities, namely:

- Review of the prospectus directive,
- Improving the availability of credit information about SMEs,
- Building a sustainable EU high quality securitisation market,
- Increasing investments in ELTIFs,
- Developing private placement markets,

are suited to achieve short-term results. However, work on these short-term priorities should not obstruct progress in further developing and integrating European equity markets, which should be, in our view, the main goal of the CMU project (see our "Background" document).

Higher equity buffers and more cross-border equity investments within Europe can generate a "double dividend" by strengthening financial stability and enhancing economic growth, provided that risks are widely spread and held by those investors who are best suited to manage them. This will require reforms and harmonisation in key areas that have been on the European agenda for years (e. g., company laws, takeover rules, corporate governance structures, and aspects of insolvency laws and tax systems). Although immediate success might be difficult to achieve in these areas, the **CMU provides a window of opportunity to resolve remaining fragmentations**.

While we agree that picking “low-hanging fruits” – i. e. completing measures that can achieve successes in the short-term – is important, it is at least equally important to take on long-term issues immediately.

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?

The role of publicly available, standardised credit information is a key difference between bank-based and market-based financial systems.[1] Gathering and processing private credit information from long-standing customer relationships is at the core of banks’ business models. Capital market investors, in contrast, have fewer incentives to continuously collect credit information since they often do not provide financing repeatedly to the same firm. Therefore, investors rely more on publicly available, standardised information that allows them to compare alternative investments.

Improving the **public availability of credit information** about European SMEs consequently would facilitate capital market investments. However, this would come at the cost of lowering incentives for investors and banks to gather private information about potential borrowers. Public information reduces the rents that they can extract from private information. The provision of public credit information could therefore affect the comparative advantage of banks. As regards policy reforms, such a potential downside needs to be weighed against the positive impact of broad access on competition in financial markets.

At the current juncture, the positive effects of enhanced information provision systems on competition certainly dominate. The **current structure of private and public credit registers in the EU is highly fragmented**.[2] Different credit registers are in place at the national level, but they are very heterogeneous in key characteristics, such as reporting thresholds or types of data collected. Some differences are due to divergent national legal frameworks. There is, for example, no consensus about whether credit registers are allowed to collect positive credit information (e. g., on-time payments). Therefore, the CMU project could establish a common, standardised framework for credit information through the following three measures:

First, the unambiguous identification of a firm is of crucial importance for the collection, aggregation, and dissemination of information on a specific firm. Thus, adequate policy measures should be implemented at the EU level to ensure that each firm, especially those that intend to access capital markets, receives a **Legal Entity Identifier (LEI)**. Furthermore, the unique identification of securities is another important

[1] De Fiore, F., H. Uhlig (2011): “Bank Finance versus Bond Finance”, *Journal of Money, Credit and Banking, 47 (7)*, pp. 1399-1421.

[2] Rothemund, M., M. Gerhardt (2011): “The European Credit Information Landscape: An Analysis of a Survey of Credit Bureaus in Europe”, *European Credit Research Institute Industry Survey.*

milestone. Therefore, the registration of all securities with an ISIN code would be highly desirable.

Second, the Commission should **conduct a mapping:** (i) of information **that is relevant** for capital market investors' decision making, in particular for equity investors (e. g., financial statements, business developments, or business plans), and (ii) of the **potential sources** of information (e. g., banks and capital market investors).

Third, **cross-border standardisation of credit information** should be promoted in order to facilitate the comparison of alternative investments. The work of the ESCB towards granular **analytical credit datasets (Anacredit) may be taken as a model for the dialogue between Member States and the Commission**. Anacredit is envisaged to collect information about loans ("loan-by-loan") and individual borrowers from reporting banks in the Eurozone, based on an ECB Statistics Regulation. However, the requirements planned for Anacredit are very complex and the data that are going to be collected in Anacredit are unlikely to be suitable for publication due to data protection and confidentiality reasons. Therefore, we do not see a need to add to the complexity, neither by trying to expand the scope of Anacredit, nor by establishing Anacredit in all Member States. Yet, we think it may be useful for the Commission to **consider the ESCB's work on concepts, definitions, and convergence in data coverage and scope** as a model for designing a credit information provision framework in the CMU.

If concepts, definitions, and data requirements were harmonised, **credit information would not necessarily have to be collected and provided by a newly established public credit register**. As long as private credit bureaus agree on fulfilling the credit information standards that arise from any harmonisation process, they can serve as providers of credit information as well, if access for all potential investors is ensured.

Finally, taking into account the confidentiality issue, publication of credit information as part of a CMU framework must **require the borrower's consent**, unless this information is publicly available anyway. All **information should also be reported back to the firm** itself. Receiving access to (i) data stored in its name as well as (ii) to the risk assessments of different lenders and investors would improve firms' ability to judge their own risk exposures, request data corrections, and provide information to support investors' investment decision making process.

3) What support can be given to ELTIFs to encourage their take up?

European Long-Term Investment Funds (ELTIFs) are an instrument to channel funds from long-term investors, such as insurance companies, into long-term investments

(e. g., infrastructure projects). **ELTIFs can lead to a more efficient allocation of capital** in the European economy. As long as it is ensured that investors are able to bear the risks from their investments in ELTIFs, the latter can also contribute to an improved risk sharing in the EU.

Whereas the regulatory framework for ELTIFs has been finalised in February 2015, the future capital treatment of investments in ELTIFs by European insurance companies is still to be decided on. Although we strongly support the ELTIF regime, the relevant **Solvency II Level 2 rules should not be set with the aim of encouraging investments in ELTIFs per se**, as this may lead to a misallocation of resources and set incentives for investors to engage in excessive risk taking. Instead, the future rules should be calibrated according to the inherent risks of ELTIF investments.

Investments in ELTIFs could, however, be supported indirectly by improving their **access to relevant credit information** – as argued for in our response to Question 2. This would help ELTIF managers to make qualified investment decisions and, thereby, make ELTIFs more attractive for investors.

4) 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?

Private placements allow the issuance of securities to a small set of investors without a stock market listing or public bond issuance. In that way they can provide access to funding to firms for which the fixed costs of public market access are too high relative to the volume of financing that they need to raise. Currently, the **European market for private placements is small**. Sizeable markets exist only in Germany (“Schuldschein”) and France (“Euro PP”), and many European firms access the U.S. market for private placements.[3] As the Commission correctly states, the European private placement market lacks transparency and harmonised documentation standards, which impedes risk assessments by potential investors. Nevertheless, it should be kept in mind that discretion about contract terms is one of the main characteristics of private placements, which limits the scope for standardisation.

Market-led initiatives have been started that aim at removing obstacles to market development by proposing common market practices and documentation standards that are compatible with a diversity of legal frameworks. Such initiatives can be a step towards a better developed and integrated European private placement market.

Considering the steps already taken, the Commission should not pursue any further action with respect to market practices and documentation standards for the time be-

[3] Nassr, I. K., G. Wehinger (2014): “Non-bank debt financing for SMEs: The Role of Securitisation, Private Placements and Bonds“, *OECD Journal: Financial Market Trends, Vol. 2014/1*, pp. 139-159.

ing. It should instead first **monitor whether investors and issuers take up the new standards**. It could additionally focus on the **establishment of a database on private placement deals**. This would allow public authorities to monitor market developments and the potential build-up of risks. A higher degree of market transparency with respect to deal volumes and structures could also increase investors' willingness to participate in the market.[4]

6) *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?*

A well-functioning, **liquid secondary corporate bond market would be beneficial for financial stability** for three reasons. First, it could smooth the effects of a sell-off during financial distress. Second, it is a prerequisite for trade transparency and information efficiency. Third, it can facilitate the use of corporate bonds as collateral as well as the dealing with risks through hedging instruments.[5] As the Committee on the Global Financial System (CGFS) states in its report on market-making and proprietary trading, "greater standardisation of bonds is one […] potential liquidity enhancer".[6]

Besides a **higher degree of standardisation**, the provision of an **efficient market microstructure** is a prerequisite for market liquidity. Among other things, this could mean supporting market making activities through adequate incentives for (potential) market makers, considering that they have to be in line with other regulatory initiatives under way. For example, regulation of proprietary trading of banks and trade transparency could potentially disincentivise some market participants from serving as market makers.

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?*

The market for ESG investments is growing rapidly. For instance, the global green bond market almost doubled in size in the first half of 2014 to a volume of $20 billion[7], but it remains only a niche market in light of the total bond market size of $80 trillion. Market-led initiatives that develop common standards already exist, and **public intervention to incentivise further investments may lead to a misallocation of capital and excessive risk taking** by investors. Regulatory standards, such as

[4] AFME (2013): "Unlocking Funding for European Investment and Growth: An Industry Survey of Obstacles in the European Funding Markets and Potential Solutions", *June 2013*.

[5] Tendulkar, R., G. Hancock (2014): "Corporate Bond Markets: A Global Perspective", *Staff Working Paper of the IOSCO Research Department No. SWP4/2014*.

[6] CGFS (2014): "Market-Making and Proprietary Trading: Industry Trends, Drivers and Policy Implications", *November 2014*.

[7] "Green grow the markets, O", (2014), *The Economist,* http://www.economist.com/news/finance-and-economics/21606326-market-green-bonds-booming-what-makes-bond-green-green-grow.

transparency standards for issuers or capital requirements for institutional investors, must adequately reflect underlying risks of ESG bonds and should not be low only for the purpose of stimulating investments in those products.

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?

In theory, a common, simplified, and high quality accounting standard could improve cross-border comparability of financial information and potentially attract listings by European and third country firms on European equity markets.[8] However, before considering the development of a new common EU level accounting standard for SMEs, the **Commission should investigate its costs and benefits** in more detail. An EU standard would be a third accounting regime besides IFRS and the national GAAPs. This would increase the overall complexity of accounting standards for compilers and users of financial statements.

Although research indicates that the mandatory adoption of IFRS has reduced the cost of equity in Europe[9], its high level of complexity and its implementation costs make it unsuitable for SMEs and rather constitute a barrier to capital market access.

Moreover, a discussion about a separate accounting standard for SMEs already took place in 2010 with regard to “IFRS for SMEs”. This standard was in the end not taken into consideration when modernising the EU Accounting Directive. Before considering a similar question again, the Commission should investigate how many companies would be affected by any proposed measures and which costs and benefits could potentially arise.

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?

Equity crowdinvesting allows spreading entrepreneurial risk across a large number of investors without the need for entrepreneurs to sell large stakes of equity interest to external investors. However, **crowdfunding is suitable for only a small subset of firms**. It could contribute to the development and integration of European equity markets only by filling a gap in financing small investments. P2P lending, a debt-based

[8] Pagano, M., A. A. Röell, J. Zechner (2002): “The Geography of Equity Listings: Why Do Companies List Abroad?”, *Journal of Finance, 57 (6)*, pp. 2651-2694.

[9] Li, S. (2010): “Does Mandatory Adoption of International Financial Reporting Standards in the European Union Reduce the Cost of Equity Capital?”, Accounting Review, 85 (2), pp. 607-636.

form of crowdfunding, can also provide a valuable source of funding for SMEs and a mechanism to channel funds to the real economy.[10]

European markets for crowdfunding – i. e. equity crowdinvesting and P2P lending – are still at infant stages of development, which is one reason why they show substantial growth rates. The European market still remains fragmented as cross-border fundraising, cross-border investments, and the establishment of foreign subsidiaries of platforms are rare. **Major obstacles to European market integration are uncertainty about applicable legislations and high costs of setting up a platform in another Member State**.[11] These are due to several reasons:

First, platforms have to comply with different EU regulations or directives, which are sometimes transposed into national law differently in different Member States (e. g., prospectus directive). Second, a variety of distinct national laws apply to crowdfunding (e. g., licensing and investor protection). Finally, applicable rules differ depending on the platform's business model (i. e. equity-based vs. debt-based or for-profit vs. not-for-profit). This causes high search costs and keeps platforms from operating across national borders.

Therefore, a harmonised EU framework for equity crowdfunding and P2P lending (analogue to the U.S. JOBS Act) could spur market development and integration. For this purpose, the Commission should first **map all applicable EU and national regulations**. The responses to the Commission's "Consultation on Crowdfunding in the EU" can serve as a basis.

Based on this mapping, the Commission could create a website where potential investors, entrepreneurs, and platform providers find information on applicable rules depending on the Member State and the type of crowdfunding.

Finally, the Commission should assess whether a **harmonised EU framework** for crowdfunding would be beneficial and if so, develop a proposal. However, it is vital that an EU framework takes an appropriate balance between ensuring investor protection and not hampering the development of the crowdfunding sector with unnecessary administrative and regulatory burdens.

A harmonised EU framework should also address potential risks emanating from crowdfunding. While it is still in its infancy in terms of volume, crowdfunding may pose **financial stability risks** (e. g., from poor credit origination and monitoring standards) to the financial system in the future if it continues to grow.

The Commission should, therefore, set up a reporting framework that allows the continuous monitoring of market development and the detection of financial stability

[10] Kirby, E., S. Worner (2014): "Crowd-funding: An Infant Industry Growing Fast", *Staff Working Paper of the IOSCO Research Department No. SWP3/2014*.

[11] European Commission (2014): "Responses to the Public Consultation on Crowdfunding in the EU", *March 2014*.

risks. Platforms should further adhere to certain minimum standards in terms of due diligence. Retention requirements that ensure loss participation by platforms could alleviate moral hazard concerns as platforms would have adequate “skin in the game”.

Finally, ensuring market transparency and reducing moral hazard becomes particularly important for P2P lending if loans are securitised and sold to banks, insurance companies, investment funds, and other market participants.

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?

A financial instrument needs to be an attractive investment opportunity by itself for markets to develop. **Introducing specific incentives to lure investors into specific assets may create financial stability risks**. It may induce a misallocation of capital and set false incentives that could induce excessive risk-taking. For instance, microprudential standards, such as risk-weights in capital requirements, should not be lowered in such a way that they no longer adequately reflect underlying risks of certain investments.

12) Should work on the tailored treatment of infrastructure investments target certain clearly identifiable sub-classes of assets? If so, which of these should the Commission prioritise in future reviews of the prudential rules such as CRDIV/CRR and Solvency II?

Infrastructure investments can enhance economic growth and could provide valuable long-term investment opportunities for institutional investors in the current low-yield environment. Infrastructure projects, however, are very heterogeneous in their characteristics and risk profiles. This makes it **difficult to define clearly identifiable subclasses of assets**.

As a guiding principle, there should not be a lowering of prudential standards, such as capital requirements, only to stimulate investment in any subclasses of assets. **Regulatory requirements must adequately reflect underlying risks**. For example, risk weights in the CRD IV/CRR or the Solvency II frameworks should be calibrated so as to mirror default probabilities rather than assigning low risk weights to stimulate investment in particular subclasses of assets.

In order to avoid that a flow of investments into a particular subclass of assets poses risks to financial stability, the adequacy of the current regulatory or supervisory framework should be continuously assessed and amendments be adopted if necessary.

14) *Would changes to the EuVECA and EuSEF Regulations make it easier for larger EU fund managers to run these types of funds? What other changes if any should be made to increase the number of these types of fund?*

The regulations on European Venture Capital Funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF) have introduced a common regulatory framework for specific types of funds in Europe. The respective regulations created “labels” and a single set of rules.

One of the key goals of the EuVECA regulation (cf. Art. 16 of the regulation) was to allow venture capital fund managers to market their funds easily to investors in the entire EU. Therefore, the regulations were supposed to contribute significantly to increase the efficiency of capital markets by channelling funds to their most productive use and improve cross-border risk-sharing.

In practice, some Member States have imposed additional requirements, such as fees, which make cross-border marketing more costly. It should be assessed whether and how the use of such requirements can be limited.

15) *How can the EU further develop private equity and venture capital as an alternative source of finance for the economy? In particular, what measures could boost the scale of venture capital funds and enhance the exit opportunities for venture capital investors?*

Although the overall contribution of further venture capital market development and integration to the CMU project is likely to be small because it is applicable to a small set of firms only, it could foster growth and employment by increasing the supply of equity financing for young, innovative firms.

Currently, **venture capital activities are concentrated in a few Member States, and cross-border fundraising and investments are low.** When third country investors retrenched during the financial crisis, this was compensated by domestic fundraising, but not by an increase in intra-EU fundraising. On the investment-side, more than 80 percent of venture capital investments in Europe are domestic (Source: EVCA data).

In general, cross-border venture capital activities are hampered by institutional and cultural differences between countries or regions, which can only partly be addressed by the CMU. But there are several areas where the CMU could have an impact.

First, the Commission could map the key rules and regulations that affect venture capital funds (e. g., tax law, insolvency regimes, and requirements for establishment of funds) and pursue the **harmonisation of rules** where fragmentation exists. Second, a public or market-led **initiative to provide information about local markets** and accompany venture capitalists when investing across national borders could re-

duce local bias. The EU project EASY ("Early-Stage Investors For High-Growth Businesses") for angel investors has shown that these are willing to invest abroad if a suitable framework for information sharing is provided.[12] A similar programme could potentially be effective for venture capitalists.

However, even under a more harmonised European framework, the majority of investments will remain domestic since venture capitalists not only provide funding, but they also need proximity to exert corporate control. Even in the U.S., where venture capital markets are highly developed, venture capitalists tend to invest locally.[13] A way to overcome geographical distance is syndication with local venture capital funds.[14] However, **syndication partners are rare in many Member States due to a lack of market development**. Therefore, the CMU should not only consider the integration of national markets as a priority, but also their development per se.

In this context, it should be noted that **European venture capital markets are "thin markets"** in which low supply and low demand reinforce each other. On the supply-side, there seems to be a lack of sufficiently experienced venture capitalists. Their experience and reputation is crucial in stimulating fundraising[15] and increasing entrepreneurs' demand for venture capital[16] because entrepreneurs gain from venture capitalists' active involvement in the business. If the CMU manages to foster venture capital market development, this will most likely attract experienced third country funds (e. g., from the U.S.) to (co-)invest in the European market and thereby improve the overall quality of venture capital supply. Furthermore, the market for venture capital exits (e. g., IPOs and M&A) should be further developed by measures as part of the CMU project (see our response to Question 32 for remarks on M&A).

On the demand-side, the number of potential portfolio companies that are suitable for venture capital investments must be increased. Many venture capital funds pursue a portfolio approach under which high returns on successful investments offset losses from failed projects. This strategy requires a sufficiently high number of businesses for venture capitalists to invest in. This could be achieved by several measures: First, the Commission should gather best practices for fostering R&D from Member States. Second, rules for setting up businesses in Europe should be simplified and harmonised. Finally, public or market-led initiatives that support firms in fulfilling the requirements of venture capital funds ("investment readiness") should be set up.

Moreover, the Commission should conduct an **analysis of the effects of governmental venture capital investments** on market development and integration. In

[12] European Commission (2012): "Report of the Chairman of the Expert Group on the Cross-Border Matching of Innovative Firms with Suitable Investors".

[13] Cumming, D., N. Dai (2010): "Local Bias in Venture Capital Investments", *Journal of Empirical Finance, 17 (3)*, pp. 362-380.

[14] Tykvova, T., A. Schertler (2014): "Does Syndication with Local Venture Capitalists Moderate the Effects of Geographical and Institutional Distance?", *Journal of International Management, 20 (4)*, pp. 406-420.

[15] Gompers, P. A., J. Lerner (1999): "What Drives Venture Capital Fundraising?", *NBER Working Paper No. 6906*.

[16] Hsu, D. H. (2004): "What Do Entrepreneurs Pay For Venture Capital Affiliation?", *Journal of Finance, 59 (4)*, pp. 1805-1844.

fact, fundraising from governmental sources increased to more than a third of overall fundraising in Europe during recent years (Source: EVCA data). Governmental venture capital has been shown to be beneficial (e. g., by leading to more innovations) as long as it is combined with private venture capital through co-investments.[17] However, history has shown that the success of governmental venture capital programmes hinges on their details.[18] Before unleashing further public investment programmes, the Commission should thoroughly assess whether investments subsidised through public funds successfully spur private investments and whether public involvement in early-stage finance leads to a larger number of firms becoming suitable for private later-stage finance.

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

As discussed in our responses to Questions 9 and 24, common European standards that limit inter alia possible risks to financial stability should be developed for P2P lending as well as for loan funds.

Furthermore, it has to be assessed how the existing **micro- and macroprudential tools** could be used to counter newly emerging risks. For example, the structural changes to the European financial system induced by the CMU project might contribute to a greater importance of asset management activities in the future. Therefore, **potential risks** in this sector **are to be closely monitored**.

One financial stability concern often voiced with regard to this sector is the possibility of "runs" on investment funds.[19] The risks stemming from such runs could potentially be counteracted by a supervisory suspension of redemptions. This specific supervisory tool is already included in the relevant European fund regulation (cf. Article 45 of the UCITS directive and Article 46 of the AIFMD). However, it needs to be further specified under which circumstances authorities could and should make use of it. In addition, it is doubtful whether supervisory authorities currently have enough up-to-date information at hand that allows them to make a well-founded decision on the activation of this tool. Consequently, the **relevant data gaps should be closed** as well.

17) How can cross border retail participation in UCITS be increased?

Through Undertakings for Collective Investment in Transferable Securities (UCITS), investors can invest in a broad range of debt and equity instruments. Thereby, UCITS increase market efficiency, enhance economic growth and improve risk sharing

[17] Bertoni, F., T. Tykvova (2015): "Does Governmental Venture Capital Spur Invention and Innovation? Evidence From Young European Biotech Companies", *Research Policy, 44 (4)*, pp. 925-935.

[18] Lerner, J. (2009): "Boulevard of Broken Dreams: Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed – And What To Do about It", *Princeton University Press.*

[19] IMF (2015): "Global Financial Stability Report April 2015", Chapter 3.

among Member States by bridging the gap between investors and projects that require external financing. The positive impacts of UCITS can unfold in two different ways.

First, retail investors could invest cross-border in UCITS that invest domestically. Second, retail investors could invest in domestic UCITS that invest cross-border. In either way, markets become more efficient and risks could be shared among retail investors across the EU, which would contribute to the efficiency of European capital markets and the stabilisation of economic growth (see our “Background” document).

To give an example: If a German retail investor invests in a DAX ETF, this does not improve cross-border sharing – independently of whether the ETF is domiciled in Germany or across the border in Luxembourg. Risk sharing would only be improved if German retail investors would participate in UCITS that are invested in other countries than Germany (again independently of whether UCITS are domiciled in Germany or in another European country).

As long as the regulatory and supervisory standards are harmonised within the EU, the fund domicile itself is irrelevant – for the individual investor, but also from a financial stability and a risk sharing perspective. What matters instead is where the UCITS invests. As it is evident that, for example, a large number of UCITS sold to German investors are domiciled in Luxembourg, we doubt that there are currently major impediments to the cross-border marketing of UCITS.

18) How can the ESAs further contribute to ensuring consumer and investor protection?

See our response to Question 25.

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

In our view, the great popularity of European UCITS among third country investors (“UCITS brand”)[20] demonstrates the **appeal of standardised, well regulated, and easy to understand investment products** to foreign investors. Therefore, the various work streams of the CMU project that aim at an enhanced standardisation of products (e. g., high quality securitisations) might also lead to a heightened interest of foreign investors in these products. In the same vein, introducing a common European framework for European Loan Funds (see our response to Question 24) could help attract non-EU investors.

[20] See e. g. BNP Paribas (2012): “Distribution of Ucits in Asia”, *Research Report*.

23) 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?

More developed and more integrated markets for debt and equity could provide valuable funding alternatives to the real economy. As a first step in improving market quality and integration, the CMU project should contain a thorough **review of the current state of markets for different financial instruments in all different Member States**. The current work by ESMA on implementing the trade transparency requirements of the reviewed MiFID could provide valuable input to this review. The identification of needs for action should then be based on the findings with respect to market liquidity and efficiency in the respective market segments.

For European public equity, bonds, and derivatives MiFID II and MiFIR already comprise many initiatives that aim at improving transparency and functioning of the market. Enhanced transparency requirements, for example, have the potential to increase the efficiency of the price formation process. This may improve market liquidity particularly for fragmented markets.

However, the **technical standards for the transparency frameworks need to be calibrated carefully** in order not to be counterproductive as regulators face a trade-off between transparency and liquidity. The market impact of large trades can lead to high volatility in transparent markets, especially if the respective financial instruments are rarely traded. If the transparency framework is not appropriately designed, market participants may draw inferences from trade data about the positions of other market participants and react strategically to those insights. Market participants may also opt for OTC-trading in order to avoid the disclosure of trading strategies since there is no obligation to trade non-equity instruments on trading venues under MiFID II/MiFIR. Thus, liquidity on trading venues may decrease as a result of very strict transparency requirements.

Similarly, very strict contractual obligations for market making may cause some participants to restrict their trading activities, which would lower market liquidity. The same holds for measures that aim at improving liquidity in secondary markets for private placements or private equity. Changing their critical features through standardisation and transparency requirements might undermine potential other positive developments in primary markets.

In terms of cross-border securities trading activities, more than ten years ago the “Giovannini Group” identified barriers that prevent efficient cross-border clearing and settlement in the EU[21] and offered suggestions on how to remove them.[22] Many of these and other barriers have already been removed or will at least partly be ad-

[21] Giovannini Group (2001): “Cross-Border Clearing and Settlement Arrangements in the European Union”, *November 2001*.
[22] Giovannini Group (2003): “Second Report on EU Clearing and Settlement Arrangements”, *April 2003*.

dressed by the introduction of TARGET2-Securities and the CSD-Regulation. However, it was shown, for example, by the European Post Trade Group[23] – a joint initiative by the European Commission, the ECB, ESMA, and the industry – that there is still room for further improvement (e. g., regarding cross-border shareholder transparency, corporate actions market standards and withholding tax procedures). Given that dismantling barriers to cross-border securities transactions contributes to risk sharing and therefore to the ability to absorb shocks, the work of the European Post Trade Group should be continued.

24) In your view, are there areas where the single rulebook remains insufficiently developed?

A single rulebook on capital markets regulation would set the foundation for the CMU. An important area for further development of the single rulebook is the **regulation of loan funds in Europe**, i. e. AIF that either invest in non-securitised loans (Loan Participation Investment Funds, LPIF) and/or that grant loans directly (Loan Origination Investment Funds, LOIF).

Although the AIFMD provides for a common basis as regards important regulatory aspects (liquidity management, leverage, due diligence requirements), the specific **regulatory framework for these investment vehicles remains fragmented** across Europe. Some Member States, such as Ireland, have introduced regulatory frameworks for loan funds; some have so far abstained from introducing specific rules. And others, such as Germany, do not allow the setting-up of LOIFs; still, LOIFs from other Member States can be marketed in Germany by way of the European Passport.

This regulatory patchwork is unsatisfactory for at least two reasons. First, it leads to legal uncertainty for asset managers and potential investors. For example, it is often unclear under what circumstances funds are allowed to grant loans in different Member States. Also, currently, it is still an open question how to differentiate between fund and securitisation structures. This uncertainty may keep investors from engagements in these markets.

Second, whilst loan funds could be an alternative source of financing for European firms, they can also be a source of substantial financial stability risks. Open-ended credit funds could be susceptible to investor runs because of maturity mismatches. In the absence of specific regulation, inadequate lending and credit monitoring standards could raise default risks and undermine investors' trust in loan funds. In particular if loan funds are highly leveraged, contagion risks might arise.

Loan funds should therefore be subject to adequate harmonised European regulatory standards. To avoid the risk of regulatory arbitrage, those **standards should be**

[23] European Post Trade Group (2013): "The European Post Trade Group (EPTG) Annual Report 2013".

comparable to those for banks where similarities arise. A harmonised framework at EU level would further limit spillover of risks from the fund domicile to other Member States. In our view, the future rules for loan funds should include the following:

- Lending and credit monitoring standards,
- Restrictions on the use of leverage,
- Loan funds should only be allowed to be set up as closed-end funds,
- Diversification rules,
- Additional reporting requirements that allow for a Europe-wide risk monitoring,
- Additional investor information,

As regards LPIFs, **risk retention requirements** would further ensure that the fronting banks have adequate "skin in the game", which would limit moral hazard concerns.

In addition to capital markets regulation, there are several other policy areas that directly or indirectly impact on the structure and integration of European capital markets. The need for reforms of takeover rules as well as specific aspects of taxation and insolvency laws should therefore be assessed within the CMU project (see our responses to Questions 29, 30, and 32). Moreover, investors face the risk of sudden changes in key national legislation. This "political risk" leads to risk premia on equity and debt investments that weaken capital market integration and private sector risk sharing. This makes it desirable that the Commission encourages Member States – for instance through the structured dialogue on the CMU – to ensure legal certainty for capital market investors.

25) 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?

We are currently not aware of any areas where a further centralisation of supervision in Europe – or (otherwise) giving the ESAs additional powers – could contribute to the goals of the CMU.

Although the Commission's report on the operation of ESAs and the ESFS has indicated that there is room for improvements in supervisory convergence, we do not consider changes or amendments to the existing allocation of supervisory responsibilities necessary. The ESAs should continue to contribute actively to convergence along these lines.

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

In principle, a further harmonisation in securities ownership rules may be expedient. However, past discussions in various expert groups at EU-Level (but also in other international fora) showed that any harmonisation going beyond the Geneva Securities Convention will be very hard to achieve as securities law is very much enshrined in national property and insolvency law. Therefore, it is doubtful whether the potential benefits associated with such further harmonisation outweigh the costs. In any event, before more legislative action is proposed, one should await the impact that the advent of T2S will have on this issue.

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?

In its Green Paper the Commission suggests to **review corporate governance regulations** in order to increase companies' attractiveness to external investors. In general, we welcome such a review as corporate governance is key to resolving problems of asymmetric information and moral hazard between investors and the management of a company.

For instance, owners of many SMEs could be reluctant to give away corporate control to external investors. This reluctance hampers the development and integration of equity markets in the EU. Strengthening minority shareholder rights – as suggested by the Commission – could weaken the incentives of entrepreneurs and existing shareholders to issue external equity finance. At the same time, corporate governance regulations may also have a non-negligible effect on (cross-border) mergers and acquisitions.

Therefore, the Commission should conduct a thorough analysis of the impact of current corporate governance practices and of potential changes on both the supply of equity capital as well as on the willingness of companies to issue equity instruments.

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

A reform of European insolvency laws could contribute significantly to equity market development, financial stability, and economic growth. Two areas are particularly important. First, **efforts to harmonise substantive insolvency laws across Member States could increase legal certainty for investors** and facilitate cross-border investments. Second, insolvency law plays an important role in the post-crisis deleveraging process and the efficient reallocation of capital in the European economy. As

explained in our “Background” document, insufficient post-crisis deleveraging in the European private sector has held back growth. The postponed deleveraging is partly due to the fact that insolvency proceedings in Europe are often lengthy, inefficient, and costly, in particular for SMEs.[24] A **more effective insolvency law that allows swift recovery or liquidation in a predictable and transparent manner would facilitate debt restructurings and the reallocation of funds to their most productive use**. It would also increase the likelihood that viable businesses do not end up in inefficient liquidations. This could consequently facilitate dealing with legacy assets on banks’ balance sheets, foster future investment in innovation and employment, and thus aid the return to economic growth.[25]

Yet, it has to be taken into account that there are extremely divergent positions with regard to collateral and its treatment in insolvency proceedings, where some Member States have insolvency regimes which complicate the realisation of collateral while others recognise them in their totality. The same holds true for silent privileges of tax authorities, social insurance and labour claims, which some Member States fiercely defend while others abolished them decades ago in favour of a plain equal treatment of senior creditors. Such differences are deeply rooted in Member States’ legal systems. Harmonising only selected areas of insolvency laws has the drawback that these areas probably cannot be fully segregated from other non-harmonised areas, which might impair legal certainty.

Nevertheless, in our view, the CMU could be taken as an opportunity to start a process of reform and harmonisation of substantive insolvency laws in the EU. European and national insolvency rules should be reviewed in order to **detect weaknesses in investor protection** that keep small, diversified shareholders from investing.[26] Moreover, a reform of insolvency laws could be an opportunity to **improve their effectiveness** in liquidating unviable firms and saving viable ones. The Commission should conduct further analyses to identify areas of insolvency law where harmonisation would be most beneficial to the development and integration of capital markets in general, and equity markets in particular. For information on differences between Member States’ insolvency regimes the analysis by the International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL)[27] provides a useful starting point but additional research might be needed. The Commission has already considered the results in its “Recommendation on a New Approach to Business Failure and Insolvency” in March 2014. While this recommendation addresses important

[24] Bergthaler, W. et al (2015): “Tackling Small and Medium Sized Enterprise Problem Loans in Europe, *IMF Staff Discussion Note 2015/04*.

[25] Liu, Y., C. B. Rosenberg (2013): “Dealing with Private Debt Distress in the Wake of the European Financial Crisis”, *IMF Working Paper No. 13/44*.

[26] La Porta, R. et al. (1997): “Legal Determinants of External Finance”, *Journal of Finance, 52 (3)*, pp. 1131-1150.

[27] INSOL (2014): “Study on a New Approach to Business Failure and Insolvency – Comparative Legal Analysis of the Member States”.

aspects of “restructuring plans”, it refrains from addressing differences as regards formal insolvency proceedings.

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?

In our view, tax policy could support the goals of the CMU project in two main areas.

First, **most Member States’ tax laws are biased towards debt** as interest expenses are tax-deductible, but equity disbursements are not. Several empirical studies suggest that non-financial firms[28] and banks[29] respond to this distortion by increasing their leverage. Removing the debt bias in national taxation laws therefore could strengthen the equity base of both the non-financial and the financial sector, which would generate the “double dividend” of stimulating economic growth and enhancing financial stability.

In Belgium, for example, the introduction of an “allowance for equity” resulted in a reduction of leverage in domestic companies.[30] A similar measure has been proposed by the “German Council of Economic Experts” for Germany.[31] Removing the tax debt bias, a topic already discussed for several years in some Member States, should be a major building block of the CMU agenda. This could be achieved at EU level through the ongoing work on a “Common Consolidated Corporate Tax Base” (CCCTB), as in Article 12 of the text currently discussed in the Council. In case a common European solution will not be feasible, Member States should consider eliminating the bias in their national tax regimes.

The second major area of tax policy that could affect the goals of the CMU is the **Financial Transaction Tax**. While the effectiveness of a Financial Transaction Tax in terms of addressing the key deficiencies that contributed to the financial crisis can be questioned, any future implementation of this tax should at least not counteract key goals of the CMU. For instance, the tax should not aggravate illiquidity risks in key markets, and it should not “penalise” the trading of equity instruments vis-à-vis debt instruments.

[28] Feld, L. P., J. H. Heckemeyer, M. Overesch (2011): “Capital structure choice and company taxation: A meta-study“, *Journal of Banking and Finance, 37 (8)*, pp. 2850-2866.

[29] De Mooij, R. A., M. Keen, M. Oriharai (2013): “Taxation, Bank Leverage, and Financial Crises”. *IMF Working Paper No. 13/48*.

[30] Princen, S. (2012): “Taxes do affect corporate financing decisions: The case of Belgian ACE“, *CESifo Working Paper: Public Finance, No. 3713*.

[31] Sachverständigenrat (2013): “Duale Einkommensteuer zur Verbesserung der Eigenfinanzierung und Investitionstätigkeit inländischer Unternehmen“, *Jahresgutachten 2012/2013: Stabile Architektur für Europa – Handlungsbedarf im Inland*, pp. 219-244.

32) 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?

In our view, the **CMU should seek to facilitate cross-border M&A transactions** in the EU for the following reasons. First, M&A could contribute to a better risk sharing through cross-border equity holdings (see our "Background" document). Second, improving the environment for M&A could increase economic efficiency and growth by improving capital allocation and creating economies of scale across the EU. Third, a larger market for M&A could stimulate equity investments in other market segments (e. g., venture capital) because M&A provide exit opportunities for equity investors. Finally, M&A can relieve financial constraints of target firms, particularly for relatively small firms, by granting access to capital markets and within-company-funding.[32] Since M&A transactions can increase market concentration and have adverse effects on competition in European product markets, possible reforms should be coordinated with competition policies.

Institutional barriers to M&A remain prevalent in the EU. As an example, the Take-over Bids Directive allows Member States to opt out of Article 9 ("obligations of the board of the offeree company": prohibits actions by the board that may result in the frustration of the bid, paragraph 2 and 3 are optional) and/or 11 ("breakthrough clause": this article is aimed at specific barriers to takeover bids, such as restrictions on the transfer of securities, restrictions on voting rights, etc.).[33] Additionally, national governments are allowed to block M&A under certain circumstances, i. e. on ground of public interest.[34] Corporate governance rules, such as "golden shares" (e. g., shares that give its shareholder special voting rights), may also impinge upon M&A activity.

Therefore, the Commission should analyse to what extent institutional barriers to M&A exist and how significant they are. In this context, a **review of the Takeover Bids Directive and relevant national laws**, e. g., company and competition laws, may be useful. In addition to M&A, we highlighted other issues that should be addressed by the CMU, but are not discussed in the Green Paper, in our responses to Questions 23 and 24.

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[32] Erel, I., Y. Jang, M. S. Weisbach (2015): "Do Acquisitions Relieve Target Firms' Financial Constraints?", *Journal of Finance, 70 (1)*, pp. 289-328.

[33] Hopt, K. (2014) "Takeover Defenses in Europe: A Comparative, Theoretical and Policy Analysis", *Columbia Journal of European Law, 20 (2)*, pp. 249-282.

[34] Jones, A., J. Davies (2014): "Merger Control and the Public Interest: Balancing EU and National Law in the Protectionist Debate", *King's College London Dickson Poon School of Law Legal Studies Research Paper No. 2015-12*.