Comment

on the Consultation Document of the European Commission
"Capital Markets Union Mid-Term Review 2017"

Federation of German Industries (BDI)
Association of German Chambers of Commerce and Industry (DIHK)

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General comments

The Federation of German Industries (BDI)[1] and the Association of German Chambers of Industry and Commerce (DIHK)[2] expressly support the political efforts being undertaken to create a Capital Markets Union. A true single market for capital that reduces the fragmentation of Europe's capital markets can improve business sector's access to financing, provide new sources of funding for business and increase the efficiency and stability of the integrated European capital market. From the real economy perspective, the priority areas for action are reviving the securitisation market, facilitating access to bond and equity markets, the financing of infrastructure investment and the support of venture capital and equity financing.

BDI and DIHK explicitly acknowledge the progress that has already been made towards building a Capital Markets Union. Efforts going forward should, however, ensue with a keen sense of proportion and without illusions. The individual EU Member States each have their own financial traditions, corporate structures and financing needs. It is thus primarily a question of strengthening the tools that interlink bank financing – at the heart of corporate finance in Europe so far – with capital market financing. The digitalisation drive in the financial industry, buzzword fintech, is also opening up new channels for capital market financing. Conventional bank-based financing for business can be combined and optimised with the many different forms of digital finance now available. The Capital Markets Union should make full use of the whole spectrum of these options without prejudice and establish a practicable regulatory framework for the digital financial industry.

The Capital Markets Union should always also be based on the financing needs of the real economy. Technological transformation is bringing great change to corporate financing. New, more complex business models and stronger networking between companies is making risk assessment increasingly difficult for the financial industry and clearly showing the limitations of standardised third-party rating, which generally serves as the entry ticket to capital markets. Organising an effective risk transfer to the capital markets is thus a key component of smooth corporate financing. The bank-based European financial system needs stronger support from capital markets. An intelligently planned Capital Markets Union would provide a more robust basis for conventional bank lending to the real economy. The Capital Markets Union could thus make a positive contribution to increasing investment, growth and employment in Europe. All of these factors should be the objectives of a well-functioning Capital Markets Union. The inherent logic of the Commission' initiative appears to be at odds with its Action Plan of 30 September 2015.

There is a large gap between the aims of the European Commission and the Capital Markets Union that is actually taking shape. The regulatory burden for the real economy and the

[1] The Federation of German Industries (Bundesverband der Deutschen Industrie, BDI) is the umbrella organisation of German Industry and industry-related service providers. It represents 40 industrial sector federations and has 15 regional offices in the German Laender. BDI speaks for more than 100.000 private enterprises – 98 % small and medium sized – employing around 8 million people.

[2] The Association of German Chambers of Commerce and Industry (Deutscher Industrie- und Handelskammertag, DIHK) is the central organisation for 79 Chambers of Commerce and Industry, CCI (Industrie- und Handelskammern, IHKs) in Germany. All German companies registered in Germany, with the exception of handicraft businesses, the free professions and farms, are required by law to join a chamber. Thus, the DIHK speaks for more than three million entrepreneurs. They include not only big companies but also retailers and innkeepers. This gives the association considerable political influence. It does not represent any specific corporate group but all commercial enterprises in Germany.

financial industry is high and impedes business sector's access to financing. Even regulations that seem only to impact the financial industry can ultimately also reduce its capacity to finance the real economy. More stringent regulatory stipulations, such as those imposed on the debt markets, have led to a reduction of market liquidity. There are indications that banks are withdrawing from their role as market makers, mainly due to the increasing capital and liquidity requirements, regulatory requirements for risk management, and disclosure and reporting duties imposed on them. These all run counter to the declared objective of the Capital Markets Union to open up new and increased capital market financing options in Europe.

The success of the Capital Markets Union will largely hinge on a regulatory framework that is consistent and free of contradictions. Regulatory overlaps and ambiguities should be corrected and avoided in future. This particularly applies to Level 2 and Level 3 legislation. For quality improvement purposes, the 'better regulation' principles initiated by the European Union should also be applied here. This is particularly important given the central role of the European Supervisory Agencies in defining technical regulatory standards and publishing guidelines on various fields of action of the Capital Markets Union. These kinds of activities become problematic for corporate financing if they pre-empt legislative proposals, set down divergent regulations or overstep their powers of authority.

In view of the large number of regulatory requirements that were imposed in response to the global banking and financial crisis, the European Commission initiated a critical review of the existing acquis in autumn 2015. A consultation (Call for Evidence) was carried out – in which BDI and DIHK also participated – to help establish a coherent and targeted set of regulations. The findings of the consultation should serve as the starting point for a systematic review of the entire EU regulatory framework for financial services. In this process, the financing needs of business need to be given stronger consideration. The more the numerous and extremely complex regulatory measures form a coherent whole, the more the Capital Markets Union will ultimately benefit all kind of businesses.

The following comments focus on the specific areas of action that have priority for the real economy. We have adhered to the structure of the consultation in providing our point of view on the present state of deliberations on specific measures. Supplementary proposals round off our comments on the individual areas of action.

(1) Market-based growth financing for start-ups and SMEs

A successful Capital Markets Union will broaden the range of financing options available to young growing businesses. In order to increase the appeal and prospects of setting up and growing a business in Europe for the next generation and thereby support the digital transformation of the real economy, more attention should be paid to the specific requirements involved in successfully founding, financing and scaling up start-ups and SMEs.

A number of start-ups are still failing on account of insufficient **venture and equity capital,** particularly in the growth phase. A stronger involvement of private investors who are prepared to take higher risks and make larger investments could durably boost momentum in the founding of SMEs and larger industrial enterprises. It is therefore right for venture capital to be given high priority in the context of the Capital Markets Union. Fragmented markets and the piecemeal structure in equity investment are factors that stand in the way of an effective and integrated venture capital market and equity financing in Europe. The measures initiated by the European Union to stimulate the venture capital market generally point in the right direction. However, they are still not sufficient to inject the much-needed impetus into the market for equity financing for growing companies. This problem is unfortunately not adequately addressed in the plans of the European Commission. A whole range of tax, legal and regulatory barriers need to be dismantled in order to mobilise substantially more private venture capital on a broad front.

Fintech solutions and crowdfunding have the potential to make a valuable contribution to the financing of young and innovative enterprises. However, these new forms of financing should not be overestimated. The investors here frequently still lack sufficient rating competency. Furthermore, the financial and product regulatory environment has not yet been structured in the best possible way to broadly expand the market. An attractive European regulatory framework for crowd-funding would help stimulate investment by a broader spectrum of investors. In the case of fintech solutions, the issue that most needs to be clarified is how they will be refinanced in future. At present, this works through e.g. securitisation transactions but these are unlikely to comply with the planned European framework for simple, transparent and standardised (STS) securitisations.

A smooth financing of the digital transformation will also require new responses from both national and European **funding policy** as it will be absorbing part of the undoubtedly increased risk. Existing funding programmes will need to be further developed to provide suitable financial support during the digitalisation process. Starting points here would be, e.g., expanding the range of costs eligible for funding, increasing the term of financing, providing financial support for business-to-business partnerships and greater use of risk-sharing instruments. The investments eligible for funding should include software, patents, design, training costs and further training measures as far as possible in order to provide optimal support for innovation financing.

There is high potential to develop **private placements** on the European markets. The successful German "Schuldschein" system could serve as a role model for Europe. Used in conjunction with bank and capital market financing, Schuldschein loans are a best-practice model that can further the objectives of the Capital Markets Union. The big advantage of the Schuldschein loans is that they provide medium-sized enterprises with an unbureaucratic and low cost financing alternative that is relatively easy to implement. Establishing this form of financing throughout Europe would entail standards on market practices and documentation requirements being defined by the market participants themselves rather than uniform regulatory stipulations. The successful German standard has tangible benefits for the issuers, including a secure regulatory framework, less restrictive regulations on collateral, no dependence on external ratings as is the case with bonds, fast and flexible documentation, moderate structuring costs and access to long-term third party financing beyond the scope of the company's bank. These benefits should definitely be maintained in the process of establishing a regulatory framework for private placements on a European level. An increase in the transaction costs, e.g. by stepping up transparency requirements would impede access to this financing vehicle for e.g. mid-sized business. The Schuldschein market has thus far been a high-quality market with mostly listed investment-grade companies. This high financial standing should be maintained. Broadening the quality spectrum would only give rise to new issues regarding market transparency. Companies are far less transparent for Schuldschein creditors than for the bank that sells the Schuldschein.

(2) Facilitating SME access to capital markets

In contrast to their competitors in the US, the main funding route for mid-sized companies in Europe has traditionally been bank lending. Capital market debt and equity instruments are still mainly used only by large companies. The concept that a greater number of smaller companies could benefit directly from capital market financing and thereby reduce their dependency on banks is, in reality, limited. SMEs often have less transparent organisational structures and business strategies than listed companies. Furthermore, SMEs frequently have specific financing needs that make it more difficult to access debt and equity financing at regular trading centres. Another reason SMEs often avoid capital markets is that the associated disclosure and transparency requirements can present a major challenge for them. The objective of according greater weight to capital market financing is nonetheless right, particularly in light of the tightened regulatory requirements in the bank lending business and the resulting reduction in the financing capacity of banks and the range of medium and long-term financing terms.

The **prospectus requirements** are being modernised in a drive to facilitate access to the capital market for mid-sized companies. The regulations set down in securities legislation do indeed often impose very high burdens on issuers. Disclosure regulations need to achieve a better balance between protecting investors and avoiding bureaucratic burdens for issuers. We therefore support the revision of the prospectus legislation. Expanded and new exemptions from the prospectus requirement and less complex requirements in drawing up a prospectus – e.g. the EU Growth Prospectus – would facilitate access to capital markets for mid-sized companies in particular. Factors that need to be considered here are that the rating structure of SMEs and, in particular, the investment regulations of funds and insurance companies, may prevent the acquisition of such securities. Yet market-making for private placement exclusively with private investors is not realistic without this group of investors. One of the unresolved issues in the latest compromise reached in trialogue negotiations was how the stipulations on the presentation of risk factors in the prospectus should be implemented. The details need to be clarified in the course of the Level 2 measures to provide the required legal certainty. To achieve the intended outcome of facilitating access to capital, the planned amendments should not increase the administrative burden and costs for companies as this would slow down the issuing process and run counter to the declared objective of the Capital Markets Union.

In the last few years, there have been **numerous initiatives** in various **EU Member States** to facilitate access to the capital market for SMEs. Italy and Germany, for example, introduced SME bonds and the Deutsche Börse launched a new SME segment for high-growth companies in early March 2017. However, there should be no illusions regarding the use of EU corporate bond markets by SMEs. The cumulative default rate of German SME bonds of currently around 40 percent is reason for caution. A high-yield bond market for SMEs would be the wrong signal for the Capital Markets Union. Nonetheless, the real economy does need alternative debt financing on the capital market beyond corporate and SME bonds. Institutional investors are needed here who are willing and able to finance even the higher-risk parts of the capital structure. Unfortunately, the regulations make it difficult for institutional investors to do so irrespective of the actual risk-return ratio.

The Capital Markets Union should focus on enabling market participants to develop practicable solutions themselves. While harmonised accounting standards and high disclosure requirements are a basic precondition for the functioning of capital markets from the perspective of investors, these same requirements often involve high fixed costs for the issuers, and particularly for SMEs, that run counter to the objective of facilitating market access. In view of the heterogeneous financial traditions within the EU, most probably, there will always be national differences in the most appropriate scope and level of harmonised accounting standards and disclosure requirements. The Capital Markets Union should therefore aim to provide a legal environment in which best-practice solutions can be found. An equal, but not necessary identical, access to information for all market participants is one of the preconditions for broader and deeper capital markets.

(3) Supporting long-term, infrastructure and sustainable investment

Institutional investors could play a much larger role in the financing of infrastructure, where needs are set to increase in the medium and long term. Investors with a long-term investment horizon, such as insurance companies, investment funds and pension funds, primarily need a stable investment environment and an attractive regulatory framework. **Constricting rules and regulations**, such as tighter capital and restrictive liquidity requirements for banks, high capital requirements for insurers, the unfavourable regulatory treatment of private bond financing compared to governmental borrowing and the barriers in securitisations are obstructing the allocation of private capital to infrastructure projects. The Commission's proposals to adjust Solvency II and review the Capital Requirements Regulation (CRR) with a view to considerably lowering the capital requirements for insurances and banks, could provide effective support for infrastructure financing in Europe.

To open up the whole spectrum of the capital markets to long-term infrastructure financing, public-private **cooperation schemes** should be institutionalised to a greater extent. **Issuing regional project bonds** and bundling them through national or European development banks and the use of **securitisations** could also give small-ticket infrastructure projects access to capital market investors.

The **European Long-Term Investment Fund** (**ELTIF**) regulation is a step towards facilitating long-term investment, particularly in infrastructure projects and real estate. Time will tell whether and to what extent ELTIF gains acceptance on the market. Treating infrastructure investments as a separate funding category in the regulations could increase the appeal of ELTIF and other long-term financing vehicles to investors. The **European Fund for Strategic Investments** (**EFSI**) that was implemented two years ago as a central building block of the Juncker Plan could help close the investment gap in Europe. First evaluations of the EFSI show that the investment campaign has so far proceeded according to plan. The fund should however only be used to finance investment projects that bring real added value to the European economy and could not be financed by other means. The EFSI falls short of our expectations in this respect. Seemingly, not all projects meet the criterion of additionality and some projects could have been financed by the market without the EFSI. We welcome the fact that this weakness is now being addressed in the legislative proposal to extend the EFSI. In our opinion, however, the target that at least 40 percent of EFSI projects should contribute to international climate goals is illogical and arbitrary, as the EU is also pursuing objectives related to the Digital Single Market, the Energy Union, the industry ratio, etc., with the fund. Furthermore, the EFSI and the ELTIF will only mobilise the intended volume of private investment if the investment environment is coherent overall. This key building block of the Juncker Plan, which is not least the responsibility of the EU Member States, still leaves much to be desired.

The Capital Markets Union must not be confined to dismantling financial barriers in a narrow sense. It is just as important for the financial and real economy to have tried and tested instruments at their disposal that **hedge against currency risks and interest and commodity price risks** and support a favourable economic environment for long-term investments. Effectively hedging against operational risks is in many cases only possible with the use of customised OCT derivatives but a number of regulatory interventions have increased the difficulty and cost of using these instruments. The main factors undermining the foundations for smooth long-term financing in the areas of energy supply, transportation, communication, the real estate sector, digitalisation etc. are the regulatory requirements on derivative trading set down by the European Market Infrastructure Regulation (EMIR), the Net Stable Funding Ratio (NSFR) and the earlier and higher risk provision included in the impending introduction of the new International Financial Reporting Standards (IFRS) 9.

(4) Fostering retail and institutional investment

Insurance companies, pension funds and asset managers could play a bigger role as investors in equity capital. The share proportion in insurance companies' portfolio has declined steadily in the last few years with rates far below the legally permissible amount. The restrictive regulatory requirements, particularly the higher capital requirements for stock investments as per Solvency II, need to be reviewed in order to prompt a rebound.

Given the costs and benefits involved, institutional investors are not likely to build up 'research' capacities that will enable them to acquire SME shares. Besides, due to the limited market making potential and low transaction volume of SME shares, external financial analyses that are "compliance-guaranteed" are not available on the market.

In view of the width and depth of the capital markets for corporate financing, a greater involvement of **retail investors** would be desirable. The increasing information duties in an effort to improve consumer protection are making securities consulting increasingly complex and thus more cost-intensive for financial institutions. As a result, many banks may withdraw from this segment and offer only comparatively low-cost, automated services. This will ultimately undermine the objective of the Capital Markets Union to increase the product range in the retail sector as well. The existing product regulation requirements should be reviewed as to their actual usefulness and practicability.

(5) Supporting banks in their financing role

Effective and competitive banks play a key role in capital markets and thus in a well-functioning Capital Markets Union. The initiative to build a Capital Markets Union therefore needs to proceed hand-in-hand with maintaining and expanding the functional capacity of a strong banking system.

A decisive starting point for the interlinking of bank and capital market financing is the **further development of the securitisation market in Europe.** This may help free up bank capital currently tied in lending. To that effect, such release will allow SMEs, whose demand for bank-based financing is particularly high, to benefit from additional bank credit. On account of the large number of heterogeneous, company-specific financing needs, banks' loans to corporates have very divergent properties (e.g. regarding underlying collateral). The fact that these transactions are not based on standardised credit relations makes them a natural candidate for synthetic securitisations. The more standardised transactions in the area of trade receivables and for leasing and consumer loans could also be considered for the true sale securitisations. In this context, issues regarding transfer of ownership, servicing, etc., are easier to resolve for these types of transactions than for more individualised bank loans in corporate financing.

The further development of the securitisation market in Europe therefore goes beyond reducing banks' regulatory capital requirements to provide new scope for SME lending. Auto asset-backed securities (ABS) stabilise large parts of the automotive value chain in Europe. More and more companies are using the market for asset-backed commercial papers (ABCP) to mobilise trade receivables. These forms of financing that are not based on credit ratings can preserve existing credit lines, which is an invaluable advantage for companies particularly given the pressure on banks to consolidate their balance sheets in the wake of the crisis. The securitisation of lease receivables through ABCP could help support the refinancing of the leasing business, which is gaining increasing importance as a corporate financing instrument. Securitisation could also make an important contribution towards Europe's high infrastructure financing needs. The basic approach of the European Commission to simplify securitisations of verifiable high quality is therefore right in principle.

Unfortunately, the progress achieved thus far in negotiations on this initiative is not encouraging. The definitions and terms under discussion are still far removed from practical requirements. The legal uncertainty associated with the process of regulatory recognition of STS securitisation is high. The disproportionate increase in capital requirements even for future STS securitisations in comparison to current market standards does not take sufficient account of their proven quality. Further, there is currently no level playing field to comparable forms of investment such as covered bonds and government bonds, which is a major competitive disadvantage for securitisations. The amendments proposed by the European Parliament will not lead to much progress here. On the contrary, increasing the risk retention requirement and the stipulation that only institutional investors may invest in securitisations are high obstacles for a well-functioning securitisation market. Such measures would exclude industrial enterprises, for example, from buying ABCP.

The proposed STS securitisation regulation will not achieve the intended efficient interlinking of corporate financing by banks and the capital markets if it does not adequately take account of synthetic securitisations. SME loans in particular would be suitable for synthetic securitisations. However, a distinction should be made here between arbitrage synthetic transactions (AST) and balance sheet synthetic transactions (BSST). AST have damaged the reputation of the term but they have nothing to do with covering portfolios of debt finance on banks' balance sheets. BSST have on the other hand been used successfully in Germany in the securitisation of corporate loans for the last 15 years. They are simpler and more efficient to carry out than true sale transactions as no legal transfer of credit or collateral is required. They are implemented in a similar fashion to loan loss guarantees and usually have cash collateral, i.e. the capital received by the issue of credit linked notes are available to the collateral taker to satisfy its losses. This makes synthetic securitisation an ideal instrument to intelligently connect bank and capital market financing and possibly also to involve national public development banks and the European Investment Fund.

The current state of reform of the CRR appears to significantly hinder the further development of this particularly important aspect of the Capital Markets Union. Banks, in particular, cannot benefit from the lower capital requirements of the STS securitisations. They would be permitted to hold synthetic securitisations of corporate loans but not STS securitisations, which could provide significant regulatory capital relief. As originators, banks could theoretically benefit from the lower capital requirements of STS securitisations. However, the demand of a SME threshold value of 70 or 80 percent of companies with sales under 50 million euros in the securitisation portfolio prevents German banks from being able to use this instrument. SMEs of this size are usually financed by smaller banks, which, in turn, do not have direct access to the securitisation market. The current proposals are therefore not conducive to broadening the use of synthetic securitisations and thus the transfer of risk of SME loans to the capital market.

Low interest rates in conjunction with more stringent regulatory requirements and increasing competitive pressure brought about by digitalisation is squeezing the margins in the lending business of financial institutions. This environment is also having a negative impact on earnings from securities transactions, securities underwriting and proprietary trading. The prospect of decreasing earnings is making it more difficult for financial institutions to build up their equity capital base and thus reduces their leeway for corporate financing. One of the factors hampering the pick-up in bank lending in several EU Member States is that **non-performing loans in the balance sheets of banks** in these states are reducing their scope for new lending. This situation harbours major risks for the financial stability and process of economic recovery in Europe. These EU Member States should take vigorous action to address their banks' problems. A stringent solution here needs to include the capital markets, appropriate winding-up and restructuring regulations and a competition policy framework that enables banks to clean up their balance sheets. An EU-wide simplification and harmonisation of the fragmented standards for non-performing loans regarding the definition of non-payment and default is also urgently required.

The European banking sector will only be able to fulfil its role in providing financing if it is on a **level playing field** with the international competition. The proposals currently discussed by the Basel Committee on Banking Supervision (here: Basel IV) do not take sufficient account of the specifics of the European financing landscape. The low risks of established SME lending may not be adequately represented. The new regulations would further escalate the regulatory capital requirements and thus the regulatory costs for European banks and reduce the volume and terms of financing offered. Internal risk models should therefore remain integral components of a balanced global financial order.

(6) Facilitating cross-border investing

Numerous **tax regulations** in EU Member States are obstructing the development of an integrated and deeper capital market. Capital gains tax imposed on the dividends of cross-border portfolio investments represents a particular barrier to the Capital Markets Union in the EU. Equity investment is generally subjected to double taxation, on the level of companies and shareholders. The tax regime in the EU Member States should increase incentives for long-term saving and corporate investments. A major obstacle for a well-functioning Capital Markets Union is the planned introduction of a financial transactions tax under enhanced cooperation rules, as is currently under discussion. This kind of tax would ultimately make the European capital market less efficient and less competitive, which would be detrimental to the financial sector and the real economy. The financial transactions tax contradicts the objectives of the Capital Markets Union.

The **legal, regulatory and supervisory system** plays a key role in the European integration of capital markets. Capital, liquidity and legal structures are in many cases based too much on national options, which impedes the full development of a single capital market. A uniform regulatory framework that fosters the further development of pan-European financial institutions of sufficient size, diversification and capitalisation would be a welcome development. To achieve this, legal amendments will be required e.g. to create an EU banking charter, establish a central banking authority on one level, and common regulations and standards for such institutions. A major factor in restoring market confidence and further building the Capital Markets Union is uniform EU supervisory structures that clearly define the options and discretionary powers of the competent authorities. The move of the European Banking Authority (EBA), which is necessary because of Brexit, provides an opportunity to review and adapt the present European System of Financial Supervision.

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