



# Green Paper Capital Markets Union

## Position paper

---

### **General remark**

This position paper on the Green Paper Capital Markets Union is a joint reaction of PMT Pension fund for Metalworking and Mechanical Engineering, the Pension fund for the Metal and Electrical Engineering Industries (PME) and their service provider MN.

We endorse the reaction provided by the Pensioenfederatie, the organization representing Dutch pension funds. In this position paper we briefly state our own position, and we provide further explanations and details to the questions asked in the Green Paper.

### **Introduction**

The Green Paper on Building a Capital Markets Union (CMU) is part of the European Commission's investment plan to stimulate economic growth and create more employment positions in the European Union. Thus, we see the Green Paper as one part of a larger package, aimed at improving the European economy by boosting European investments. Within the overall investment plan, the Green Paper Capital Markets Union covers two main themes:

- Increasing direct financing of European businesses (and especially SMEs) to substitute for the decreasing role of bank loans.
- Generating more private sources of financing for long term infrastructure investments.

Dutch pension funds, and the Dutch metal industry pension funds PMT and PME in particular, invest for their pension fund members. This poses requirements to the risk-return profile of investments and the associated costs. Investment projects that are subsidized and therefore yield an artificially low risk premium are not attractive from that point of view.

We already hold very large investment positions in the European economy. Close to 50% of our accumulated pension assets are invested in the European Union, and specifically 15% is invested in the Netherlands. Examples of these investments are increasing the sustainability of Dutch real estate, and financing of businesses (for instance private placements) through the 'Bedrijfsleningen Fonds' (BLF) of the Dutch Investment Institute NLII. As a follow-up to the Green Paper and the investment plan, we would like to invite the European Commission to further study these existing initiatives and investments in the Dutch economy.

## **Our remarks**

### General

- In general we support the initiative of the Green Paper, especially with regard to the intention of broadening and deepening financial markets. This may create new asset management opportunities for institutional investors.
- From our point of view, the challenge in the current extremely low interest rates environment on financial markets is to realize sufficient returns and diversification. Especially SME investments through a fund structure have the potential to do well on both accounts.

### Current limitations of legislation and regulation

- Currently, there are strong impediments to cross-border direct finance within the EU: differences in insolvency and tax laws make direct lending to enterprises in some of the other EU member states unattractive, irrespective of the risk-return profile of the investment itself. Harmonization of insolvency and tax laws is necessary to address this issue.
- Currently there is no European reporting and accounting standard for non-listed enterprises. This complicates the decision process on direct financing, as there is no universal way of reporting financial statements. Introduction of basic reporting and accounting standards would facilitate the decision process, and thus make it cheaper and more efficient.

### Risk-return and cost-efficiency

- As stated above, we invest for our pension fund members, which poses requirements to the risk-return profile of investments. Investment projects that are subsidized and therefore yield an artificially low risk premium are not attractive from that point of view.
- The risk-return profile is also influenced by prudential requirements. These shouldn't be disproportionately tough on SME and infrastructure investments. Punishingly high capital requirements for these investment categories make them unattractive for investors.
- SME investments are of interest only when they can be done in a cost-efficient way. If gross returns are attractive, but the investment costs are very high (for example because gathering the information for the decision on which enterprises to finance is very costly), then the net returns will be unattractive.
- This argument holds for the SMEs looking for funding as well: the more expensive the process is, the less attractive looking for funding outside banks is. Cost-efficiency is very important for both SMEs and potential investors.

### The role of banks and asset managers

- The Capital Markets Union should not be about alleviating the balance sheet of the banking sector. Therefore, the Capital Markets Union should not be about passing on bank loans to other financial institutions through securitizations. We are not opposed to securitizations in general, but using them will not help in decreasing the dependence of European businesses on bank loans.
- Currently, banks are the only institutions that have the necessary expertise to judge credit requests. Moving to an economic environment where a (much) larger share of corporate credit is provided through direct finance requires specialized asset managers. Investors provide funding, and businesses send their credit requests to the asset manager, who matches supply and demand.

- A good first step towards the emergence of these specialized asset managers would be to start matching supply and demand on a local level. This enables them to build up expertise. Thereafter, the area of operation could be scaled up to cross-border matching of supply and demand for direct funding.

## **Answers to the Green Paper questions**

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

A major priority is increased harmonisation in laws and regulations such as insolvency law, tax laws and accounting standards. Harmonisation in these fields will increase transparency and facilitate investors in their due diligence and decision-making on whether to provide funding or not, thus making the direct finance channel cheaper and feasible for a broader set of investors. This could be added as a sixth priority.

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?*

In general, the availability and standardisation of credit information helps investors in their judgment and decision-making and thus increases the likelihood of investment. A good example is the impact that the introduction of IFRS has had on companies listed in regulated markets. Therefore, standardisation of SME credit information should be stimulated.

However, for some SMEs publicly sharing certain information may not be desirable, as this is competitively sensitive. For these parties the use of private placements or being financed by a specialized SME asset manager may be better options. With private placements, the information is only shared with a number of interested investors. When being financed by an asset manager, only the asset manager obtains the information. Therefore stimulating the development of these two channels of financing will also have a positive impact on deepening the SME market.

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

No comment.

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?*

There are indeed market-led efforts to establish common credit information standards for the private placement markets and it would be valuable if the EU would support these efforts.

Furthermore, it is essential that prudential regulation does not impose capital requirements for private placements that are too harsh, i.e. such that the investor cannot earn enough on the investment compared to what it 'costs' in terms of capital requirements. At the moment, 'unrated' debt investments are barely attractive because of capital requirements, while these may be good investments in itself. Supervisory authorities may want to evaluate existing capital requirements on private placements, as this needs to change before the market for private placements can truly take off.

Finally, harmonization of insolvency laws across member states will strongly facilitate the growth of a cross-border private placement market. See for further elaboration on this point our answer to question 29.

5) *What further measures could help to increase access to funding and channelling of funds to those who need them?*

Harmonisation and standardisation in insolvency laws, accounting and reporting standards for non-public companies will facilitate the emerge of (cross-border) direct funding. Further, standardisation of investment products and an increase of the specialized SME asset management industry.

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?*

More central trading and enough market makers to ensure there is sufficient liquidity could help increase the attractiveness of corporate bonds.

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?*

Pension funds place high value on integrating ESG criteria in their investment decisions. There are a number of organisations that facilitate dialogue and cooperation between pension funds and other institutional investors on the topic of responsible investment. In our view, there is no strong need for additional action by the EU in this area.

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?*

Yes. A common accounting standard would aid investors in judging risk and return, and decrease the costs of analysing credit proposals by SMEs due to differences in. The current IFRS regime is too burdensome and especially too costly for many SMEs to be used for this.

We have no comment on whether this should be achieved specifically via SME Growth Markets.

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?*

No comment.

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?*

Before thinking about policy measures that could incentivise (institutional) investors to allocate a larger share of their asset portfolios to SMEs and start-ups, two points need to be addressed.

First, the essential feature of assets/investments that governs their attractiveness is the risk-return profile<sup>1</sup>. If the risk-return profile is not attractive - i.e. the asset or investment is too risky compared to the excess return it offers -, then it is not obvious why an investor would want to invest in it, irrespective of policy measures.

Second, 'long-term projects' are not well-defined in the Green Paper. Without a clear

---

<sup>1</sup> Pension funds are trying to provide adequate pension benefits to their participants. 75% of pension benefits is earned by investment returns, which makes the risk-return properties of the assets invested in very important.

definition of what the Commission considers to be long-term projects it is hard to make sensible statements. For the remainder of this answer we will therefore focus on SME financing, which will be done in principle through fund structures and asset managers.

Assuming investments (and specifically SME/start-up investments) that have an attractive risk-return profile, there are two main impediments to the successful emergence of SME funds and asset managers. The first is the variation in documentation of investment proposals by SMEs. This makes evaluating the investment proposals a difficult and time-consuming procedure. Moving towards standardized documentation and accounting rules for SMEs would greatly facilitate and reduce the costs of investing in SMEs.

The second impediment are the prudential rules. SME investments are considered illiquid and risky under most prudential frameworks, and therefore carry high capital requirements. This makes them unattractive relative to investments that are deemed more liquid and/or less risky.

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

In our opinion, the costs of setting up funds are not really a problem currently. Benefiting from economies of scale in SME financing is difficult. On the one hand, the demand for investments is not high enough to reach a large scale easily within a single member state. On the other hand, fund managers that try to realize economies of scale by going cross-border run into the problem of differing regulations on insolvency, documentation and accounting per member state.

*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?*

In general, infrastructure investments can be supported by prudential rules that do not require disproportionately high capital requirements. As mentioned earlier, the risk-return profile of the infrastructure investments themselves are essential for attracting investors.

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

This question deals with third pillar, private pensions products. Since we are second pillar occupational pension funds, we have no answer to this question.

*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?*

No comment.

*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?*

Private equity and venture capital have been developing strongly over the last years, and currently form a well-developed source of financing in European member states. The

main impediment to further growth of private equity and venture capital financing is the often negative approach by politicians and the press. A more positive approach to private equity and venture capital would foster an investment climate in which institutional investors would feel more comfortable investing larger parts of their asset portfolios in these asset classes.

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

Bank lending: no comment.

Non-bank direct lending: the lack of standardized documentation and accounting standards are serious obstacles for funds and asset managers that aim to channel investments in companies that need finance, as is the lack of harmonization in insolvency regulation across member states.

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

No comment.

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

No comment.

*19) What policy measures could increase retail investment? What else could be done to empower and protect EU citizens accessing capital markets?*

No comment.

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

No comment.

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

See our answer to questions 8, 10, 11 and 16: the lack of standardized documentation and accounting standards are serious obstacles for investing in companies that need finance, as is the lack of harmonisation in insolvency regulation across member states.

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

No comment.

*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?*

In general, more central trading and enough market makers would increase both transparency and liquidity of bond markets.

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

In the last few years, we have seen a lot of regulation aimed at the financial sector. As indicated before in the answers (see our answers to questions 10 and 16), it is not lack of financial sector regulation, but lack of standardized documentation and accounting standards and insolvency regulations for companies requiring finance that form an impediment to further development of non-bank direct lending through fund structures and asset managers.

*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?*

As stated in the answer to question 24, it is not regulation of the financial sector that needs further developing, but standardization in several regulatory areas around SMEs.

*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?*

No comment.

*27) What measures could be taken to improve the cross-border flow of collateral? Should work be undertaken to improve the legal enforceability of collateral and close-out netting arrangements cross-border?*

Close-out netting of notionals significantly reduces counterparty credit exposure, up to 85% according to a 2010 paper by ISDA<sup>2</sup>. By netting out OTC derivative positions, market parties are not faced with large swings in market prices following the default of a counterparty, because the necessary amount of rebalancing is significantly reduced. Netting also increases transparency about the net exposure to the counterparty, which reduces uncertainty. Thus, improving legal enforceability of netting arrangements has a positive impact because it reduces market volatility following a default. Under Central Clearing, Clearing members also expect netting because it decreases the Risk Weighted Assets (RWA) and thus capital demands on the bank balance sheet.

The collateral flow of cross-border transactions can be improved by way of a Bridge entity. A Bridge entity is a legal entity where positions with a defaulting counterparty can temporarily be placed. This keeps these positions and exposures safe, instead of closing them following the default. Subsequently, the position can be transferred from the Bridge entity to a different counterparty (subject to the condition that this is an approved counterparty).

The creation of Bridge entities requires a new legal framework, including legal opinions that contain a clear structure of obligations and entitlements in case of default of a market party. Because we use Title Transfer in our Credit Support Annexes (CSAs), when a counterparty default leads to the use of a bridge entity, we remain entitled to collateral that has been placed specifically with us.

*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?*

---

<sup>2</sup> <http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf>

Recently, work on the Shareholders' Right Directive has been undertaken. Currently still lacking is an effective set of EU rules for minority shareholder protection. A minimum, pan-European set of rights for shareholders to hold boards of companies accountable to shareholders would greatly help to establish this effective protection.

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

There should be more clarity about the applicable jurisdiction in case of an insolvency.

In practice, assets are kept by custodians and sub-custodians in different jurisdictions. In case of an insolvency, this triggers not only the insolvency law in the member state where the branch is located, but insolvency law in the member state where the assets are located as well. A common situation is that assets of a Dutch investor are kept under the sub-custody of a French sub-custodian of a UK custodian, which in its turn is a branch of a US bank. Currently, it is very difficult for an investor to determine in case of an insolvency of for example the UK custodian, which laws will apply. It is unclear how the various insolvency laws of the different jurisdictions interact with each other in case of an insolvency, and what the resulting consequences will be for the investors' assets.

For instance, in case of insolvency it is not clear whether the investor has access to his assets, or whether the investor has a right to set off. Currently, it is possible that investors that have both a debit and credit position have to pay their debit position, but it is not clear at all whether he will receive the full amount or even part of his credit position at the end of the insolvency procedure. The investor then runs the full credit position risk (even if net exposure is much lower). Also, insolvency procedures can last for many years, increasing the risk the investor runs.

Finally, the differences in insolvency laws across member states form an impediment to cross-border investments within the EU. These differences lead to uncertainty, and often very burdensome in default situations. This makes direct investments in different member states unattractive.

*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?*

The reclaim of withholding tax procedures is a very demanding process. Each country has its own set of forms and formalities that needs to be fulfilled. These forms and formalities differ from country to country.

The tax treatment of various type of investors or the investment vehicles they use is not always clear upfront. In that case the investor has to approach the local tax authority first to obtain a ruling on the tax treatment of an investment vehicle. When local authorities are not willing to do so, this can have an impact on, for example, tax reclaim processes. If it is not clear that an investor can apply a withholding tax exemption upfront then it needs to apply the tax reclaim procedure. It then takes more time to obtain the amounts unduly back (in some cases 10 years).

These issues can be addressed by moving towards a uniform system of tax reclaim. One such example could be the TRACE initiative by the OECD.

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

No comment.

*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?*

No comment.