THE LONG-TERM FINANCING OF THE EU ECONOMY

A Green Paper issued for comment by the European Commission

Comments from ACCA (Transparency Register No 4227861124-34)
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SUMMARY

ACCA welcomes the Commission's publication of the Green Paper and supports the goal of creating a business environment which promotes a more long-term focus in planning and investment.

We welcome the Green Paper's comprehensive analysis of the present situation, one which takes into account a wide range of variables that have a bearing on the issue under review. There is one aspect that we feel receives inadequate attention, and that is the current and potential future role of equity finance. The changing nature of public and private capital means that it is extremely difficult now for businesses to finance growth by debt. Financing today's technology-based businesses is typically only possible through equity, and for this reason this channel of funding should assume a greater role in the Commission's financing strategy. Given the hope being invested in the private sector, and especially SMEs, to spearhead the return to growth, wider access to equity funding for the SME sector should be an important element of any long term strategy.

Another significant dynamic which we believe the Commission must acknowledge in its plans is the capacity of private businesses to plan effectively to meet their financial needs and manage their affairs on an on-going basis. Research undertaken in the UK suggests that businesses that have financially trained staff and are able to produce regular management accounts are more likely to be successful when applying for finance. Yet only a minority of SMEs have trained staff and produce regular accounts, and even fewer produce, additionally, business plans. There is also evidence to the effect that innovative projects are more likely to fail because of internal financial management defects than due to a lack of external funding. Accordingly, any comprehensive strategy on this issue needs to emphasise the need for strengthening the financial capability of SMEs.

With regard to the Commission's interest in exploring whether current technical standards on fair value accounting contribute to an undesirable focus on the short term, it must be recognised that the purpose of these standards is to provide information which is decision-useful for investors. Fair values are always likely to be appropriate in respect of financial investments, especially for equities, since those values are likely to be up to date and reflect current investment options. The alternative basis of valuation, historical cost, is not a good alternative where reliable fair values are available – the longer the investments are held, the more irrelevant that cost model would become.

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We agree that the supply of and access to long-term financing is a necessary prerequisite for the adoption of long-termist business strategies. We would not wish to suggest though that the long term focus is or should be the required norm in all circumstances. Individual enterprises and investors may well have different time horizons, and these should be respected. In a diverse business environment, it should be seen as healthy for entrepreneurs to be able to create and manage companies to achieve short term objectives. Also, whatever the time horizon of individual businesses, it is likely that most will have a range of capital needs, and short-term liquidity financing will in all likelihood be a prominent element of those needs. In seeking to enhance the long term perspective in planning and investment, the contribution that short term funding can make to sustaining business activity should not be devalued.

The above notwithstanding, the recent financial crisis has shown that any business which aspires to being successful over the longer term must consciously adopt strategies to bring this about and have access to sources of funding which facilitate them. We support efforts to encourage and push companies to do this. Goals and targets which appear to be attractive in the short-term should be considered to be secondary to the goal of creating value in the longer term, and companies should be encouraged in different ways to appreciate the business benefits of planning for sustainable growth. Rules on the ways that businesses are governed and managed, and report on their performance, make up part of the framework that can help achieve this outcome.

To bring the desired change about will require not only action by companies but supportive behaviour by investors, market players and wider society. The business environment in general must develop in a way which is not characterised disproportionately by an expectation of immediate results. Investment activity which is intended to generate income for expressly long term purposes, in particular pension saving funds, should adopt a much clearer focus on the long term. And on a wider political level, it has to be accepted that a greater concentration on the longer term will inevitably mean businesses and individuals foregoing consumption in the short term and, if necessary, imposing regulatory restraints on business activities which offer the prospect only of short-term or socially irresponsible profit.

In the following pages we comment only on those issues and questions that are of direct relevance to our remit.

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SPECIFIC COMMENTS

Q1 Do you agree with the analysis regarding the supply and characteristics of long-term financing?

The Green Paper provides a robust analysis of the present situation. It does though overlook at least one significant issue – that of the changing nature of public and private capital. This has important implications for the types of funding required and the market failures likely to impede its supply.

For much of the last twenty years (see Figures 1 to 4 in the Appendix), fixed capital formation in Europe has increasingly been driven by investments in computing and software. The value of this capital is in turn strongly related to intangible assets (including human capital) whose value is context-specific, which tend not to produce significant cashflows immediately upon investment, and which cannot, in most cases, be used as collateral. As a result, it is now possible for entirely successful businesses to be built that can nonetheless pledge neither their own assets nor the founder's wealth as collateral, and are guaranteed to remain cash-negative for a long period of time.

Moreover, the rising importance of network effects in the online economy (which are further amplified by social media) means that, increasingly, technology-enabled businesses are engaged in 'winner-take-all' contests where returns on investment are highly contingent (Andrews and de Serres 2012).[1] Finally, businesses growing in the manner described above can often blur the line between capital and operating expenditures as they seek to build intangible assets (Damodaran 2012).[2]

These features of the 'new capital' make it extremely difficult to finance through debt. Financing such capital relies on finance providers being prepared to take losses in the majority of cases, which is unsustainable unless they are exposed to the full upside of their investment. This is typically only possible through equity, which should ideally take on a much greater role in financing EU enterprises.

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[1] Andrews, D. and de Serres, A. (2012), 'Intangible Assets, Resource Allocation and Growth: A Framework for Analysis' *OECD Economics Department Working Paper* No. 989, Paris: OECD Publishing. http://dx.doi.org/10.1787/5k92s63w14wb-en Accessed 6 June 2013

[2] Damodaran (2012) 'The Dark Side to Valuation: a Jedi guide to Valuing difficult-to-value companies.' http://pages.stern.nyu.edu/~adamodar/pdfiles/country/darkside2012extended.pdf Accessed 6 June 2013

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The analysis provided by the Green Paper does not devote enough attention to equity financing, even though the share of SMEs using or preferring to finance themselves through equity is still very small (c 7%), and recent evidence suggests that ever fewer EU SMEs find equity financing relevant to their business (IPSOS MORI 2011) as economic growth continues to falter.[3] On the other hand, more detailed research has in some cases uncovered a substantial amount of informal equity injections. By mid- 2013, an average of 13% of UK small and medium sized enterprises (SMEs) had had money injected into them by their owners within the last year as an exclusively long-term investment. Another 11% had received cash injections with an *element* of long-term investment (BRDC 2013).[4]

Outside the commercial sphere, other investments creating intangible capital, most notably education, suffer from financing shortcomings similar to those of the new capital. Yet governments insist on financing those through a mixture of public and private debt, and recording them in national statistics as consumption rather than investment. The latter point may appear trivial, but it can bias a number of policy-relevant calculations, from the measurement of consumer price inflation (CPI) to the setting of fiscal targets, in a way that further discourages the building of intangible assets.

Overall, these facts suggest that the role of equity in the long-term financing of the EU economy will need to be bolstered and in some cases the treatment of intangible assets by funding providers will need to become more sophisticated – improving their valuations and their ability to be used as collateral.

While much of the discussion on long-term financing rightly focuses on the supply side and its limitations, it is also based on the assumptions that individuals and organisations are fully aware of their financial needs and can plan these in the long term, are able to navigate a changing landscape of financing opportunities, and are able to make their case convincingly to finance providers. Such assumptions are not, in our view, justified. A substantial amount of economic output, jobs and ultimately welfare in Europe depend on the financing of SMEs, individual consumers, even some government agencies, whose level of financial capability doesn't match their long-term ambitions.

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[3] Ipsos MORI (2011) 2011 *SMEs' access to finance survey.* Brussels: European Commission, December http://ec.europa.eu/enterprise/policies/finance/files/2011_safe_analytical_report_en.pdf Accessed 7 June 2013

[4] BDRC Continental [BDRC] (2013) *SME Finance Monitor Q1 2013: The uncertainty of demand.* London: BDRC http://www.bdrc-continental.com/EasySiteWeb/GatewayLink.aspx?alId=6345 Accessed 7 June 2013.

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In the UK, the findings of the SME Financing Monitor (BRDC 2013), one of the largest-ever surveys of SME access to finance, consistently demonstrate that businesses which have financially trained staff managing their finances, and who are able to produce regular management accounts, are more likely to be successful when applying for finance. Yet only a minority have both of these in place – 12.3% of the total population of UK SMEs and just 43% of SMEs with 10-49 employees. Even fewer combine all three with a formal written business model, which is particularly important for obtaining long-term finance. Equity finance is even more demanding, and European SMEs are much less likely to feel confident discussing their needs with venture capitalists or business angels than banks (IPSOS MORI 2011).

Financial capability is a constraint even when organisations do not need to use external finance. An ACCA-sponsored 2011 survey of European executives (Forbes Insights 2011)[5] found that innovative projects championed within European companies were more likely to fail because businesses had failed to budget for them and earmark appropriate resources than due to a lack of *external* funding. After controlling for a wide range of other influences, the study also found that innovative projects were significantly more likely to succeed in businesses with more competent finance functions (ACCA 2013a).[6]

In light of these and other similar findings, we believe that support for access to finance needs to emphasise the strengthening of in-house financial capability among SMEs, making it possible for them to link long-term finance and long-term business planning. Professional accountants have a role to play in providing advice as well as building in-house capabilities. After all, while the role of finance professionals varies by country, their reputation as expert finance advisers to SMEs is universal (Schizas et al 2012).[7]

Q2 Do you have a view on the most appropriate definition of long-term financing?

In our view, long-term finance should be primarily defined not in terms of the maturity of financial claims but in terms of the following considerations:

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[5] Forbes Insights (2011) *Nurturing Europe's Spirit of Enterprise.* New York: Forbes Insights. http://www.accaglobal.co.uk/content/dam/acca/global/PDF-technical/small-business/europe_insightsfin2.pdf Accessed 3 June 2013

[6] ACCA (2013a) *Accountants for Small Business* London: ACCA http://www.accaglobal.com/content/dam/acca/global/PDF-technical/small-business/pol-afb-afsb.pdf Accessed 14 June 2013.

[7] Schizas, E., Jarvis, R. and Daskalakis, N. (2012) London: ACCA http://www.accaglobal.org.uk/content/dam/acca/global/PDF-technical/small-business/rr-127-001.pdf Accessed 7 June 2013

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1. the alignment of long-term *interests* between the provider and the recipient,
2. the willingness of the former to accept risks that are difficult to quantify or project.
3. the creation of valuable tangible or intangible capital.
4. when financing businesses, a recipient organisation that is a going concern and is treated as such by finance providers.
5. finance providers willing to *hold* any assets resulting from financing to maturity or over a significant period of time (see below). Where secondary markets exist in which such instruments are traded, *investors* may be characterised as 'long-term' investors according to their investment policies.
6. A financing *relationship* to which both parties dedicate appropriate resources, and in which they each accept the other party as a legitimate stakeholder in how the finance in question is sold, structured, priced, rationed, and used.

With this rationale in mind, the 5-year threshold suggested in work done for the G20 should only be seen as a *starting point* for this exercise.

In the case of investment in businesses, especially SMEs, principles (1) and (2) outlined above might dictate a lower threshold of around 3 years. This is comparable to the typical time angel investors remain invested prior to a failed exit (Wiltbank 2009),[8] and the typical time in which high-impact firms are likely to demonstrate their full potential (Delta Economics 2012).[9] In our view, investments above this time horizon indicate an expectation of long-term viability, and, more importantly, a willingness to share significantly in the downside should an investment fail.

In our view, illiquidity is not in itself a necessary feature of long-term finance, but it *is* likely to contribute substantially to the chances of market failure. Hence, while it should not be referenced in the *definition* of long-term finance, it will need to be addressed nonetheless in any measures taken to encourage long-term finance.

[8] Wiltbank, R.E. (2009) *Siding with the Angels* London: NESTA, May http://www.nesta.org.uk/library/documents/Report%2021%20-%20Business%20Angel%20Inv%20v11.pdf Accessed 31 May 2013.
[9] Delta Economics (2012) *High Growth SMEs: Understanding the Leaders of the Recovery.* London: ACCA, July http://www.accaglobal.co.uk/content/dam/acca/global/PDF-technical/small-business/pol-tp-hgs.pdf Accessed 31 May 2013

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Q5 Are there other public policy tools that can support the financing of long-term investment?

Given the severe government budget constraints on member states we believe that new solutions are needed to support the financing of long term investments. Therefore, we see significant potential in states pooling resources to co-ordinate cross border projects, particularly in areas such as in transport, energy and communication networks. However, there will need to be a clear corporate governance framework in place for managing the risks, clarifying lines of accountability and decision making and project management, as well as an assessment of efficiencies.

We would also mention here that there is little recognition in the analysis provided in the Green Paper of the role of public private partnership (PPP) schemes. We believe that such schemes represent a very useful source of long-term investment, and must therefore form part of any new framework on this matter. That being said, we would sound a note of caution. Research suggests that PPP schemes, when badly planned and managed, do not produce the public and financial benefits they are supposed to bring about, suggesting that they should only be used were they can plausibly demonstrate a clear benefit for taxpayers and citizens. In the UK, for example, whilst the use of such schemes has undoubtedly allowed the country to stimulate short-term economic growth in some areas, they have produced significant long-term debts, required government bail-outs and led to constraints being imposed on the way that public bodies are able to use their assets. Value for money (VFM) analysis should therefore always form a key part of decisions on PPP schemes. Another relevant factor to consider in this context is whether public sector bodies have the level of skills necessary to make schemes work. Research published by ACCA in 2012 - 'PPP/PFI round the world' – found that the right skill sets are not always available and, where they are not, materially impair the schemes' chances of success. It must also be recognised that private financing in the form of a PPP offers both opportunities and risks to a government, and management of these risks is essential if there is to be a genuine sharing of both the gains and the associated risks between the public and private sectors.

Question 10: Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?

ACCA has written extensively on the effects of the new capital and liquidity requirements embedded in CRD IV on lending to SMEs (see for example ACCA

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(2011)[10] and ACCA (2012)[11]). In our earlier publications we called for an assessment of the impact of CRD IV on SME lending, and, to its credit, the Commission has been the first major policymaker to respond with a detailed SME impact assessment (EC 2011)[12]. This was soon followed up by the European Banking Authority's assessment of SME risk weights (EBA 2012).[13] Despite these, our concern regarding the impact of CRD IV on long-term financing capacity remains, and is three-fold.

First, we fear that apart from easy-to-model quantitative changes to interest rates and credit rationing, banks will respond to CRD IV by fundamentally changing their business models away from business and particularly SME lending. The more time banks are given to comply, the more their adjustment will consist of business model adaptation. Table 1 in the Appendix summarises the ways in which banks might choose to adapt to the new regulations. Moreover, the interaction between different aspects of prudential regulation can have unintended consequences for banking business models. For instance, ACCA has demonstrated how the UK's approach to ring-fencing in the financial sector could easily lead to most SME lending being financed by the wholesale markets under an 'originate to distribute' model (Schizas 2012).[14]

Generally speaking, capital and liquidity regulation based on risk weights effectively incentivises financial institutions to swap assets with higher risk weights for assets with lower or zero risk weights and/or move assets off-balance-sheet. Between 1991 (the year before the first Basel accord came into effect) and 2008, risk weighted assets (RWAs) fell from 66% to 33% of major systemic banks' total assets – clearly without the banks becoming any less risky

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[10] ACCA (2011) *CRD IV and Small Business: Revisiting the Evidence in Europe.* London: ACCA, December http://www.accaglobal.com/content/dam/acca/global/PDF-technical/small-business/pol-af-crdiv.pdf Accessed 30 May 2013

[11] ACCA (2012) *Basel III and SMEs: Getting the Trade-Off Right.* London: ACCA, March. http://www.accaglobal.com/content/dam/acca/global/PDF-technical/small-business/pol-af-gtor.pdf Accessed 30 May 2013

[12] EC (2011), 'Impact Assessment,' Commission Staff Working Paper accompanying the document 'Regulation of the European Parliament and the Council on prudential requirements for the credit institutions and investment firms', SEC(2011) 949 final http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/IA_regulation_en.pdf, accessed 30 May 2013

[13] EBA (2012) *Assessment of SME proposals for CRD IV/ CRR.* London: EBA, September http://www.eba.europa.eu/cebs/media/Publications/EBA-SME-Report.pdf Accessed 30 May 2013

[14] Schizas, E. 'Smart Banks, Dumb Banks, and the amazing, terrible future of small business lending in the UK' *The ACCA Blog,* 14 September 2012 http://blogs.accaglobal.com/2012/09/14/smart-banks-dumb-banks-and-the-amazing-terrible-future-of-small-business-lending-in-the-uk/ Accessed 6 June 2013.

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(Slovik 2012).[15] Since SME loans are responsible for 46% of major European retail banks' RWAs (CapGemini 2010)[16] and only 27% of their net income, they are likely to suffer if this trend persists.

Solvency II shares much of the risk-based architecture of CRD IV's predecessors and therefore also many of their flaws – particularly the incentive for regulated parties to take on systemic rather than mundane risk and safe rather than risky assets. Between 2001 and 2010, Western European insurers anticipated Solvency II by *halving* their exposure to equities outside their unit-linked businesses, instead redirecting funds to fixed-income instruments (G30 2013).[17] In 2010 terms, this equated to ca. €800bn lost to Western Europe's equity markets, mostly as a result of capital regulation.

Second, as explained in ACCA (2012), we believe that risk weights, whether internally generated by banks or handed down by regulators, are a departure from the purpose of capital regulation. The market failure addressed by capital regulation is the creation of systemic risk that banks do not internalise. Yet risk weights (*especially* internally generated ones) reflect the combination of market, credit and operational risk that banks are *best* at internalising – and fail to address systemic as well as low-probability, high-impact risks. This means that conventional lending to the real economy will still be disproportionately penalised under CRD IV (despite the recent progress in reducing the risk weights applied to SME loans) and will do so without the compensating benefit of promoting financial stability.

Third, we anticipate that proposed liquidity rules will effectively penalise maturity mismatches between banks' liabilities and their assets, as well as the reliance on some types of wholesale funding. This means that a shift towards long-term financing for businesses will inevitably require a shift towards more sustainable long-term financing for financial institutions themselves, against a backdrop of subdued equity prices and a higher cost of capital. As of 2012, European banks performed worse in terms of most liquidity measures than their

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15 Slovik, P. (2012) *Systemically Important Banks and Capital Regulation Challenges.* OECD Economics Department Working Paper No. 916, December http://www.oecd-ilibrary.org/economics/systemically-important-banks-and-capital-regulation-challenges_5kg0ps8cq8q6-en Accessed 30 May 2013.
16 CapGemini (2010) *Small Business Banking and the Crisis: Managing development and risk.* http://www.capgemini-consulting.com/sites/default/files/resource/pdf/World_Retail_Banking_Report__Special_Edition_2010.pdf CapGemini, UniCredit and EFMA Accessed 30 May 2013
17 Group of 30 [G30] (2013) *Long-term finance and economic growth*. G30: Washington DC. http://www.group30.org/images/PDF/Long-term_Finance_lo-res.pdf Accessed 6 June 2013

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peers elsewhere, and have often responded by reducing loan maturities (Le Leslé 2012).[18]

Restoring the long-term, real-economy focus of Europe's financial services industry requires an honest rethink of financial regulation. ACCA still believes that a better-capitalised financial services industry is necessary for Europe to grow sustainably, and more importantly we understand that the sheer amount of political capital invested globally in this matter means a radical overhaul of capital and liquidity regulation is unlikely, even undesirable, in the medium term. However, Europe can and should lead the initiative to develop and test alternatives or complements to the Basel III architecture which address systemic risk and do not penalise the healthy risk-taking that enterprise ultimately depends on. Similarly, it is necessary to formally take stock of the possible adverse effects of CRDIV on long-term financing and a set of policies to counterbalance these.

Taxation

Q 16 What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?

The distinction between debt and equity for tax purposes is an integral feature of the majority of global tax systems. Making any changes to that differential, even at an EU wide level, will introduce a distinction for global investors between EU and non-EU investments. While some Member States have introduced measures to equalise treatment of the two forms of finance, by giving some element of allowance for the cost of equity, it is still too early to draw useful conclusions as to their impact, especially given the wider economic background against which they have been operating, and also the differing motivations behind their introduction.

The options for removing distortions are either to 'level up' or 'level down' the treatment of the two types of investment. Removing tax incentives (deductibility) of debt financing would have a particularly disruptive impact in the light of the comparatively high gearing adopted by many businesses (albeit in specific response to that very characteristic of debt financing). Conversely, extending tax reliefs to cover the cost of equity will in the short term reduce revenue receipts and the shortfall would need to be covered somehow. Given the current downward pressure worldwide on headline rates of corporation tax announcing increases of this kind would be a courageous move for any

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[18] Le Leslé, V. (2012) 'Bank Debt in Europe: Are Funding Models Broken?' IMF Working Paper WP/12/299, December. http://www.imf.org/external/pubs/ft/wp/2012/wp12299.pdf Accessed 31 May 2013

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individual jurisdiction, and it is notable in this context that one of the motivations ascribed to the withdrawal of the Croatian allowance for equity costs was that withdrawal enabled the government to reduce the general rate of corporation tax.

Given the overall context of current funding bases, 'levelling up' through the introduction of an allowance for the cost of equity would appear to be the preferable course to removing distortions between the cost of debt and equity. Nevertheless, there would still be considerable political barriers to overcome in creating mechanisms which avoided significant impacts on either government revenues or tax burdens on business.

Q 17 What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?

National incentives should be focused on directly rewarding the long term holding of investment, rather than seeking to make the potential subject matter of investment more attractive. Various mechanisms have been experimented with, such as indexation allowances (reducing the level of gain chargeable on disposal), exemptions (excluding the gain arising from the charge to tax) or taper reliefs (reducing the rate of tax charged) by reference to the length of holding period. All such mechanisms of course introduce an element of complexity into the system. Often incentives aimed at encouraging specific types of investment, for example wealthy individuals into smaller, riskier businesses, will incorporate some element of holding period restriction, and such features could be enhanced without significant extra complication of the system.

Structural exclusion of certain types of gain from a charge to tax is likely to be the simplest mechanism, followed by adjusting the calculation of the gain, and least simple is the introduction of differential rates. However, exclusion of gains on investments held over a certain period is a relatively blunt weapon and one which will have the least predictable, but potentially most significant impact on revenues. Withdrawal or weakening of such a 'binary' relief once established would likely arouse significant opposition. Conversely, adjustments to rates or calculation processes are easier to analyse and predict, and less likely to provoke significant resistance once established.

One feature of personal investment reliefs is that they tend to attach to the individual, rather than the investment holding itself. As a result, holdings which pass by inheritance can often attract significant tax in the hands of the legatee, which would be contrary to the original spirit and intention of the legislation, being the reward of long term engagement with the investee. Allowing for

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‘intergenerational’ relief on certain types of long term investment could significantly enhance the attractiveness of such investments to older investors, who typically have greater capital to invest, while tying the recipient of the investment in to a longer holding term.

Q18 Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities?

Tax adjustments are often not the best tool to implement policy incentives. In particular, investment incentives need to be very carefully targeted. Introduction of tax expenditures is of itself a distortion to the system, reducing theoretical efficiency. Reducing tax burdens to incentivise particular behaviours relies for its impact upon the importance of ultimate tax burden on the taxpayers’ decisions making processes. There is of course the deadweight cost of those taxpayers who would have pursued the relevant course anyway they will get a ‘free ride’, with governments foregoing the revenue otherwise raised on that activity.

The effectiveness of corporate tax incentives should be measured on a wider basis, and in particular taking into account the extent to which the incentives address externalities which might otherwise not be reflected in the costs or benefits of a given activity. However, at anything but the very broadest level, such measurement inevitably runs into significant practical difficulties, as identifying the level of subsidy which might have a particular impact, the other related impacts, and the marginal effects of changes to the availability or quantum of relief inevitably rely upon increasing levels of assumptions.

Policing unintended access to tax incentives adds to complexity and administrative burdens, often on all taxpayers. There are many examples from around the world of insufficiently targeted or restricted tax incentives driving unintended behaviours resulting in significant lost revenues and additional costs. Careful design of incentives, including external consultation, can reduce the risks of poor design. Curing such issues as cannot be prevented must be carefully costed, and the marginal benefit of discouraging arbitrage assessed in a wider economic context.

Q19 Would deeper tax coordination in the EU support the financing of long-term investment?

Certainty that tax treatment is, and will remain, constant from one EU Member State to another would remove the tax incentive to shift investment from one state to another, and could hence encourage stability. The difficulties of changing a more coordinated and integrated system might also lead to greater stability in the system itself, and that long term certainty would improve

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investor confidence and likelihood of long term thinking (provided of course that the status quo is itself attractive to investors). Beyond that, the likely impact on long term saving will be dependent upon the specific features of whatever coordinated system is ultimately implemented, in accordance with the comments made above.

Accounting principles

Q20 To what extent do you consider that the issue of fair value accounting principles has led to short termism in investor behaviour? What alternatives or other ways to compensate for such efforts could be suggested?

We do not consider that fair value accounting has contributed to short-termism. Our view of the use of fair values in accounting is that, in general, in certain circumstances they are the right measure and in others other measures, such as historical cost, are more appropriate – we support a mixed measurement model for financial reporting. Focussing on investment assets as this paper does, fair values are likely to be appropriate, especially for equities because they are most relevant to long or short term investors as they are up to date and reflect the current investment options. Long-term investors need interim reports of values, and it is up to them to decide what is volatility and what might constitute the start of a trend in the value. Historical cost is not a good alternative where reliable fair values are available – the longer the investments are held the more irrelevant the cost model would become.

For bonds that are held to collect the interest and redemption cash flows then the measurement at amortised cost will be most relevant as any intervening value changes are unlikely to be realised. There is a separate question if assets are measured at fair value, ie whether the changes in fair value should be reported as part of profit for the year or as a component of other comprehensive income.

Current IFRS would allow bonds to be held at cost if held to maturity and otherwise as available for sale. Equities and bonds that might be sold before maturity would be treated as available for sale meaning that volatility in fair values are reported in other comprehensive income (OCI).

Taking the two research findings referred to (though unhelpfully neither are referenced in the document), at face value and together, would imply that a long term investment model in equities will be helped if the inherent and unavoidable volatile value changes are reported elsewhere than as part of profit for the year. That seems to us precisely where IAS39 is currently positioned, as we have shown above.

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The proposed changes coming from IFRS9 will not change this substantially – long term investment institutions will be able to adopt the OCI treatment for equities and for many bonds held for the long term they will be shown at amortised cost or at fair value through OCI

Our reservation concerning IFRS9 is the requirement to state unlisted equities at fair value even when reliable fair values might be difficult to obtain. IAS39 currently allows a cost model where this is the case. Fair value for such equities would generally be level 3 under IFRS13 and so subject to significant prudent discounts for liquidity and risk. Nevertheless we consider that where fair values are too uncertain then they are of little assistance to users of accounts, and the cost treatment should continue.

As regards alternative approaches, historical cost is the main option and we have noted above why, for long term equity holdings, that is not going to be helpful, except where fair values would be too subjective.

For these unlisted equity holdings, if the investor has significant influence as a result (as they often will) then there is an alternative treatment required – that is equity accounting as an associate (IAS28) where the investor's share of reported profits is recognised instead.

Corporate governance arrangements

Companies are to an extent driven by the investment motives of their shareholders. Company boards will inevitably be required to act in the interests of their shareholders. It will inevitably follow that companies must take into account what they perceive to be their shareholders' conception of what the benefits of investment are. While it is not possible to generalise about the motives of all shareholders, it is clear that many significant shareholders, including pension funds, seek short-term returns which exceed market benchmarks, and if they do not achieve this they will sell their investments and move to stocks which offer a better prospect of doing so. Increasingly also, investors are buying and selling shares on the market within very short times with little interest in doing anything with those shares other than making a short term profit. If substantial numbers of investors are motivated to act in such ways, and if this tendency has a material effect on companies' share prices, it is inevitable that the behaviour of company boards will be influenced. Accordingly, the achievement of a generalised commitment to long termism on the part of companies will be in part dependent on how boards can be encouraged to effectively withstand short-termist pressures imposed on them by their investors and the markets.

The issue could be said ultimately to revolve around incentives, since

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these drive behaviour. Anyone wanting to consider why many investors and boards find it difficult to take a long term view should weigh the incentives for short termism against the incentives for long termism. Incentives for short termism are many and arise from regulation, culture, custom and practice and apply to both companies and investors. Executives and others receive remuneration and/or bonuses based on short term measures. This rewards a short term focus on present share value. Competitor pressures generally encourage a short term focus. For example, a competitor who cuts costs or takes on gearing to boost short term profits at the possible expense of long term success will be rewarded with a higher share price and its executives will be rewarded accordingly. The company which does not do so may be better positioned for the longer term but risks a hostile bid and its executives will receive smaller remuneration. From the investment side, pension fund trustees will, as referred to above, appoint professional investment managers and assess their performance on the basis of quarterly movements in the value of the equity (and other) investments under their control. Separately, tax rules may encourage high gearing if interest is tax deductible. High gearing means a company has more pressure to deliver in the short term.

Q23 Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?

Yes. It should be seen as integral to good governance for the rights associated with company ownership and capital to be exercised in a way which is consistent with the interests of the beneficial owners. When very substantial levels of capital are controlled by intermediaries of one kind or another, as is the case on modern capital markets, there is likely to be a disconnect between the interests of the ultimate owners of the company and those who exercise the ownership rights. It has been argued that this situation results in companies which are effectively ‘ownerless’, and incapable of being governed in any real sense. The specific adverse effects of this disconnect can include the following:

- The substantial power wielded by intermediaries might conceivably be exercised so as to further the aims of the intermediaries themselves, rather than the beneficial owners or the investee companies. There needs to be a clear legal expectation that intermediaries should act with a conscious commitment to benefit the actual owners.

- The intermediaries may either not consider the interests of intermediaries in any targeted sense, or else see the beneficiaries’ interests in purely short-term financial terms. In both cases, the actions of intermediaries may have the effect of imposing pressures on investee companies that impair their ability to measure their own performance or plan for the future in terms other than short term financial results. From the

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perspective of the intermediaries themselves, any legal onus to which they are subject which exerts on them pressure to achieve results in those terms only risks imposing, indirectly, a material obstacle on companies' efforts to adopt a wider conception of their own performance.

- Without a direct fiduciary relationship between intermediaries and beneficial owners, there is an ineffective basis for controlling intermediaries' costs and for their disclosure. This is, arguably, a factor in the escalation of intermediary costs which in turn has the potential to distort the behaviour of intermediaries and indirectly the response of investee businesses.

We believe, accordingly, that addressing the legal relationship between intermediaries and beneficial owners is a vital element of any move to promote a more long-termist approach to investment.

Information and reporting

We believe that the framework of corporate reporting has an important role to play in the construction of a more long-termist approach to the conduct of business and to business investment so we are pleased to see that this aspect is addressed in the Green Paper.

Integral to the development of a framework which is conducive to the adoption of a more long-termist approach to investment and planning is to appreciate that companies owe obligations to society and that the expectations that society has with respect to the business community have become more demanding and more differentiated.

There is and will remain a valid rationale for traditional financial reporting but there is also a valid rationale for the disclosure of information of a non-financial nature. Some stakeholders, principally market analysts and regulators, will continue to regard the contents of financial statements, prepared in accordance with the detailed requirements of EU law and accounting standards, as being crucial to their understanding of a company's performance, stewardship and operational prospects. The regulatory framework should retain a strong emphasis on transparent financial reporting since this is the primary benchmark against which the financial stability and profitability of individual companies can be measured from period to period and from company to company.

Information that does not naturally belong in financial statements is also, however, of substantial and growing reporting significance. There are two principal drivers for the disclosure of non-financial information, both of which

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have the potential to materially enhance users' understanding of companies' position and performance.

First, disclosure can act as a generator of performance in areas where there is official or market pressure for individual companies to meet set targets of behaviour, for example, in respect of corporate governance arrangements, the representation of women on company boards, practice regarding the treatment of creditors, the emission of greenhouse gases etc. If companies choose or are required to report on their performance in respect of non-financial matters then this will act as a spur for them to improve their performance period by period.

The other driver stems more from an understanding on the part of companies, whether or not this emanates directly from stakeholder pressure, that they cannot convince their stakeholders that they have presented a complete and rounded assessment of their position and prospects (and in the process enhance their attractiveness to investors) unless they take into account all the risks and opportunities that they face and at least make an attempt to measure and mitigate them.

There is in fact an increasing realisation on the part of companies, investors and other corporate stakeholders that this wider approach to capturing performance is necessary if decision-useful information is to be prepared and presented. Research has shown that companies' performance is influenced, inter alia, by the way they treat their employees, and by the extent to which they generate trust among consumers and the public; there is also a body of thought, to which ACCA subscribes, which suggests that the 'culture' within an organisation is instrumental in determining whether a company is able to create sustainable value. the recognition of environmental factors is also vital. As the UN-backed Principles of Responsible Investment point out, 50% of company earnings world-wide could be at risk from environmental externalities – this is equivalent to 11% of global GDP. A recent report by ACCA, KPMG and Fauna & Flora International (Is natural capital a material issue?) examined in detail the potential financial costs to companies and their shareholders of the loss of natural capitals and sought to raise awareness of the business benefits of taking action on this issue and informing stakeholders about the action they take. Failure on the part of companies to take such wider considerations into account in planning their activities and reporting on their performance will risk giving an incomplete account of their performance and state of readiness for dealing with future challenges, a failure which a responsible market is highly likely to note.

Over and above the two drivers discussed above, narrative information can communicate to users what the financial statements cannot do in themselves, namely what it is that the company is and has been trying to achieve, in other words its strategy and its objectives, and the extent to which it has achieved its

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objectives during the period under review and considers itself able to achieve them going forward.

Non-accounting considerations such as those mentioned above are not only conducive to the adoption of a fuller understanding of an individual company's performance and investment-worthiness, they have the additional virtue of contributing to a longer–term perspective on investment behaviour. For this reason we strongly support the adoption, within any new framework, of a combination of financial and non-financial reporting measures.

On the specific point raised in the text about mandatory quarterly reporting for listed companies, we believe that this is the wrong approach since it is likely to encourage a focus on short-term results at the expense of an appreciation of the entity's ability to sustain a given level of performance over time. Since the purpose of financial reporting, at least under IFRS, is 'to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in providing resources to the entity', it follows that quarterly financial reporting is effectively intended to form a basis for financial decisions to be made in relation to the entity. Until such time as investors and others are presented with information in a form which is orientated more towards a long-term perspective, quarterly reporting will in our view be an inadequate basis on which to make financial decisions and may provide potentially counter-productive incentives for company directors and executives.

Q24 To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?

As indicated in the comments above, a more complete understanding of a company's performance and prospects can best be acquired via a combination of accounting disclosures and information of a more narrative nature (though the latter will often contain information of a financial character). Both types of information are useful in their own ways and users are unlikely to be able to gain more than an incomplete understanding of the company's position and prospects if they only access and interpret the one type.

We believe that increasing the degree of actual integration of the two types of information, as is being promoted by the work being undertaken by bodies such as the International Integrated Reporting Council (IIRC), has great potential to give all users of company reports a more complete understanding of the company's long term position, provided always that a concern to address the long term perspective is expressly incorporated into any 'integrated' approach.

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The IIRC's draft framework for integrated reporting, as issued for comment in March 2013, states explicitly that the purpose of this new approach to corporate reporting is to communicate 'how an organisation's strategy, governance, performance and prospects …. lead to the creation of value over the short, medium and long term.' Mindful of the importance of presenting information in a way which is understandable, and given the voluminous size of much current corporate reporting, key features of the IIRC proposals are that the integrated report be 'concise' and confined in its content to matters which are material to an understanding of how the reporting entity creates value over the course of different time frames. The draft framework also identifies the need for an integrated approach to reporting to recognise and measure the full range of factors, including the external environment, which contribute to the ability of the reporting entity to create value on that basis.

While aspects of the IIRC framework remain to be fully articulated, and understood and supported by key stakeholders, we believe that the potential benefits of a more integrated approach, in the context of the concern to promote a more long-termist approach to investment, include the following:

- A proper appreciation of an entity's longer-term prospects is not possible unless the reporting entity explains to users its corporate aims and its strategy, policies and plans for achieving those aims. Only when these matters are effectively communicated can the entity's short term financial results be viewed in their full context.

- If users are given a clear assessment of the ability of the entity to generate value over different time-scales, investors with different time horizons will be able to draw their own separate conclusions from what the reporting entity says about the sustainability of its business, and make their investment decisions on the strength of a more considered view of the entity's future prospects.

- A more holistic approach to corporate reporting would take into account not only all the known material risks to the entity's business operations but also the various factors that are likely to contribute to the achievement of the entity's aims (as well as to its compliance with regulatory obligations). Elements that may be material to the achievement of an entity's aims – such as its culture, brand and framework of stakeholder relationships – may not currently be measured and reported at all via conventional reporting; even if they are, they are not likely to discussed in a way that gives the user a reliable insight into how exactly they contribute to the creation of wealth, either in the short or longer terms, and into how any detriment suffered in relation to those

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matters would affect the entity's prospects for achieving its corporate aims.

- While the discrete reporting of information on the entity's policies and performance in the financial, governance, ethical, environmental and other spheres can be useful to stakeholders, the fact that information on those matters is usually presented in stand-alone form, with little cross-functionality, may not present the user with a view on how the entity's performance in those individual areas is connected with other areas and will not communicate a coherent overall message.

- The adoption of a more integrated approach to reporting could also encourage the adoption of a more co-ordinated approach to business planning and operational management generally, with the result that management and governance decisions would be more likely to be approached with the 'bigger picture' and the longer term in mind.

Financial statements in the traditional sense will remain of crucial importance to many investors and it is likely that this will remain the case for a long time to come. But we do believe that there is merit in expanding the scope of reporting so that it communicates a a wider and longer term view of the health of a business entity: this, we believe, will benefit both businesses and investors.

Q25 Is there a need to develop specific long-term benchmarks?

On the basis that companies and investors are likely to base their own performance targets on benchmarks that are influential in the market place, it would make sense to revisit the issue of market benchmarks to consider whether they can be better structured so as to reflect a more measured, long-termist approach to success measurement.

The ease of SMEs to access bank and non-bank financing

Q 26 What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

Q27 How could securitisation instruments for SMEs be designed? What are the best ways to use securitisation in order to mobilise financial intermediaries' capital for additional lending / investments to SMEs?

Q28 Would there be merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitised products specifically designed for SMEs' financing needs?

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We believe that, regardless of their other merits and shortcomings, capital and liquidity regulation are driving a wedge between two things long held to be matched: banks' and institutional investors' appetite for SME loans and equity products, and investors' appetite for SME credit and equity as an asset class. This is evident not only in the relative ease with which banks expect to be able to offload SME credit from their balance sheets, but also from the very strong response of entirely unsecured retail investors to the rise of peer-to-peer lenders and crowd-funding platforms targeting SMEs. In the case of credit, the gap between the two can best be bridged through securitisation.

ACCA was relieved in early 2013 to hear that the Commission and many MEPs still consider securitisation to be a useful and legitimate practice (ACCA 2013c). We note also that default rates among underlying loans in SME securitisations are low (Kraemer-Eis et al 2013). However, bearing in mind the ways in which securitisation has failed in the past, especially overseas, we would urge the EU institutions to strongly support initiatives that aim to ensure greater transparency for Asset Backed Securities (ABS), such as the newly-launched Prime Collateralised Securities (PCS) Label (http://pcsmarket.org/the-label/).

Still, as the EIF clearly notes (Kraemer-Eis et al 2013), the primary market in Europe is not really functioning, with most new issues retained by lenders, partly so that they can be posted as collateral in return for central bank funding, while nearly all issuance (86%) occurred in just two countries – Italy and Spain, where asset spreads are also lowest (Fitch 2013). Fitch clearly notes that the economics of the SME market don't work for lenders, who have much cheaper alternatives available to them. Keeping this in mind, the EU Institutions need to formally take stock of the impact of Central Bank liquidity facilities on the development of Europe's securitisation market.

We must also note that new regulations on Credit Rating Agency (CRA) liability could threaten Europe's ABS market in the same way as the original Dodd-Frank Proposals on rating agency liability caused the much more mature US ABS market to freeze before they were withdrawn. Clearly, a better balance needs to be struck between ensuring accountability, encouraging investors in new issues and avoiding over-reliance on credit ratings. We note that the debate on credit rating agency regulation closely mirrors that on regulating the audit market and trust that the EU institutions will learn the right lessons from the latter.

Overall, Europe has a unique opportunity to build the foundation for a proper market for SME credit in general, as deleveraging European banks increasingly examine the option of loan divestitures. Deloitte (2012) found that half of all major European banks expect to be involved in substantial sales of loan

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portfolios, and that private equity and investment funds are the most likely buyers. Importantly, the banks see SME loan portfolios as only moderately difficult to find buyers for.

Q29 Would an EU regulatory framework help or hinder the development of these alternative non-bank sources of finance for SMEs? What reforms could help support their continued growth?

One area in which regulatory reform could spur significant growth in SMEs' access to alternative sources of finance is the regulation of peer-to-peer and crowd-funding platforms. As these industries mature, both incumbents and policymakers are calling for regulation in order to ensure trust is maintained once the sectors begin to consolidate and the honeymoon of low failure / default rates ends. At the same time, governments with ailing banking sectors will come under pressure to protect them from the loss of deposits, making the policy environment hostile towards alternative funding providers. Thus an effective regulatory framework for this sector would need to facilitate innovation and competition without restricting access to such platforms on either the supply or the demand side.

More specifically, the Commission would need to propose a framework, consistent with current best practice among the member states, which achieves the following:

- Making cross-border funding a realistic prospect in a Single Market for p2p and crowd funding, by ensuring that Member States standardise their treatment of such platforms and do not create artificial barriers to entry.

- Developing principles-based standards for p2p regulation, such that regulatory treatment is predictably similar where users are exposed to similar risks. This could further encourage growth in member states where the industry is not yet developed, and ensure that innovators in the sector can broadly anticipate regulatory requirements pre-startup even when their business models do not resemble those of incumbents.

- Ensuring rules for crowd funding and peer to peer finance are consistent with the aspiration of an integrated market for card, internet and mobile payments.

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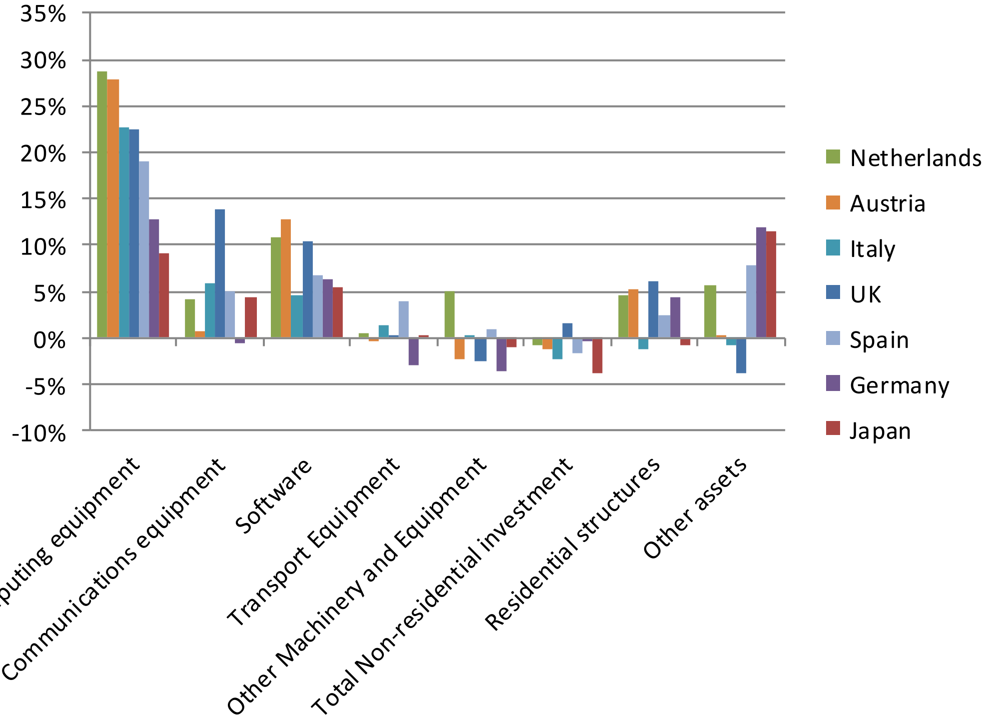
APPENDIX

Figures referred to in our response to Q1

Figure 1: Real gross capital formation – annual growth 1991-7



Source: EU-KLEMS

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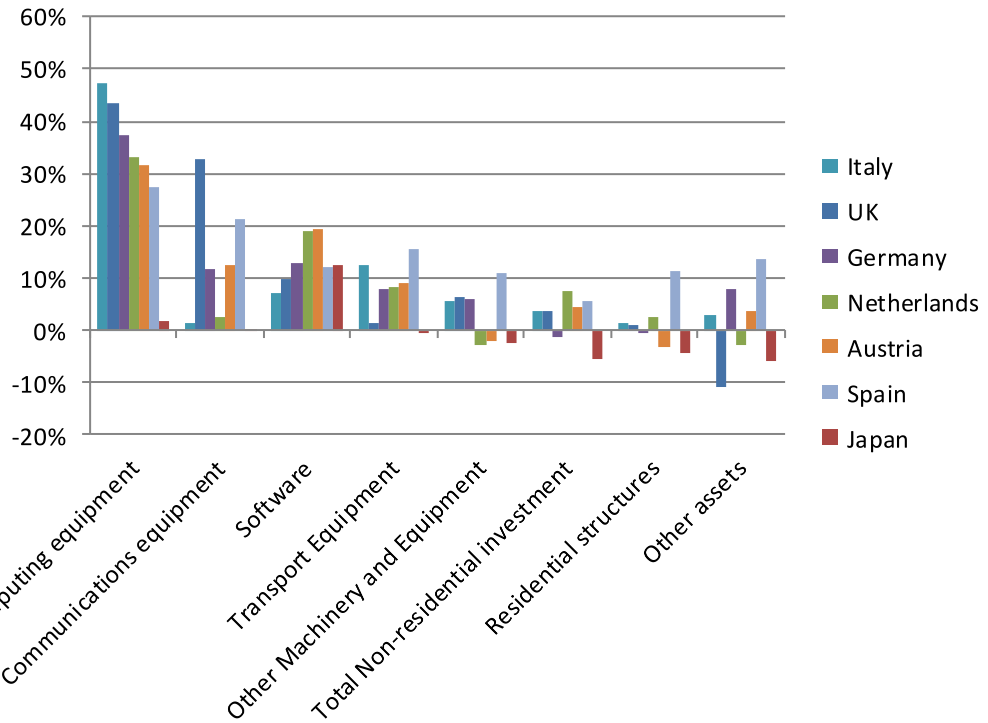
Figure 2: Real gross capital formation – annual growth 1997-2000



Source: EU-KLEMS

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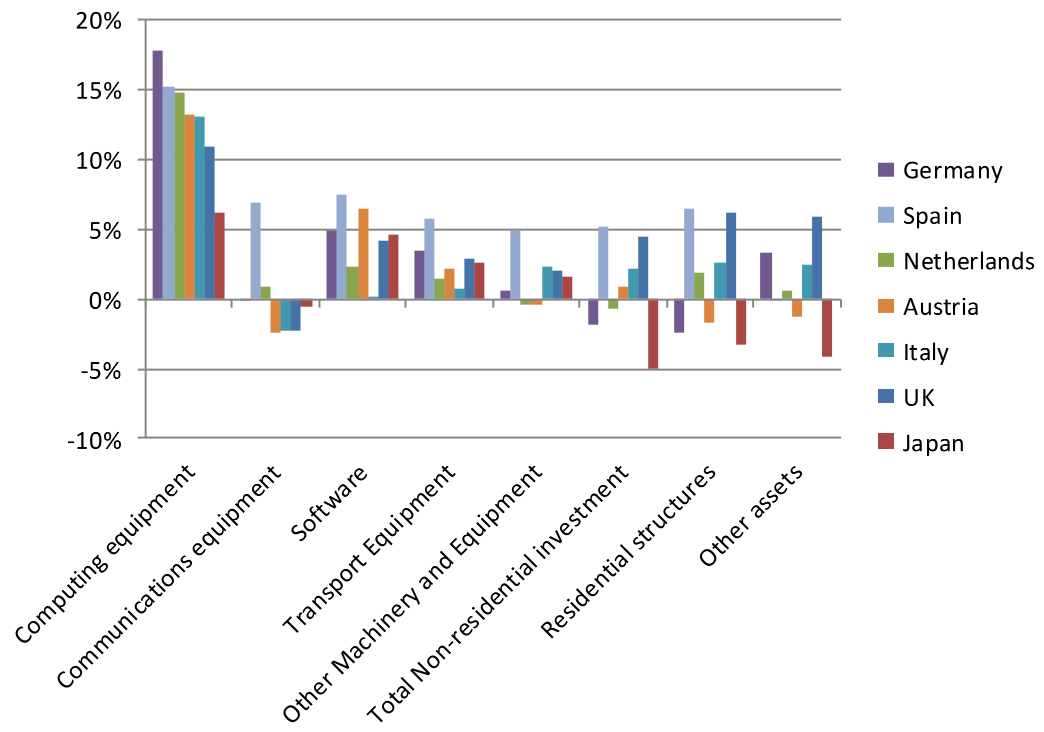
Figure 3: Real gross capital formation – annual growth 2000-2007



Source: EU-KLEMS

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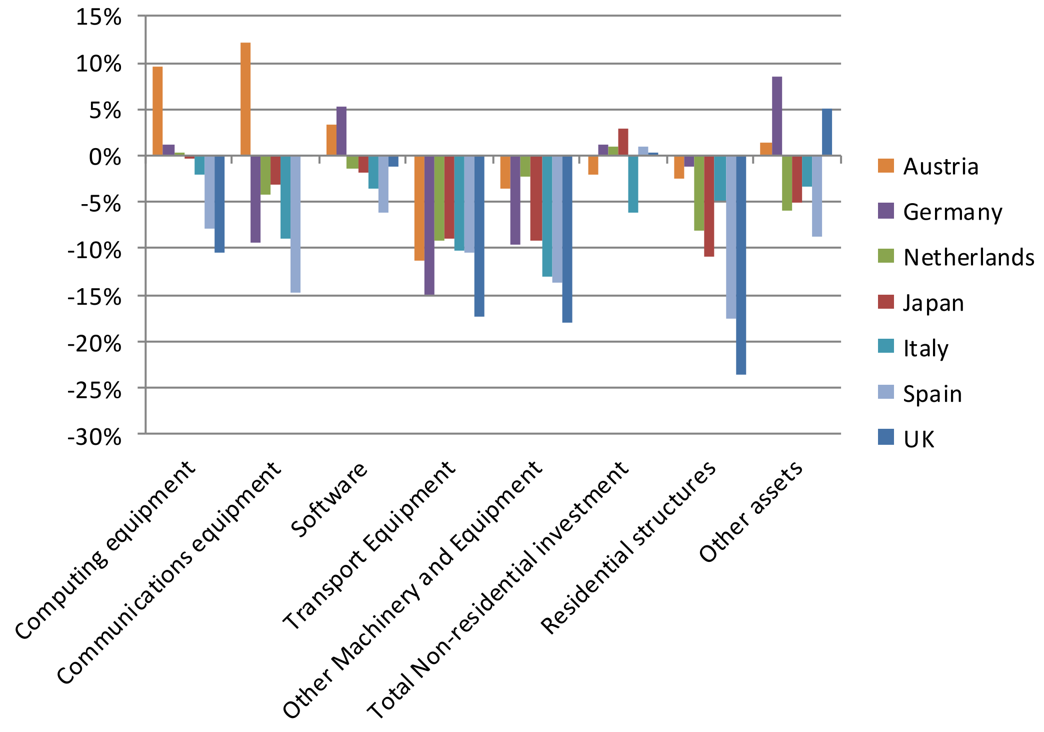
Figure 4: Real gross capital formation – annual growth 2007-09



Source: EU-KLEMS

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Table 1: Some possible responses to CRD IV and their likely effects on SME lending (referred to in our response to Q10)

Type of response	Likely impact on lending
Information	
Lenders improve risk models, data quality and internal reporting systems. Data quality is reportedly a major obstacle to SME credit management.	Asymmetry of information is greater for SMEs but where credit scoring is already in place or not an option, scarce resources will constrain banks' ability to generate additional information.
Collateral	
Lenders demand additional security or personal guarantees, including cases where they previously would not. Lenders' emphasis on collateral and guarantees increased in the aftermath of the crisis, more so than their demand for information.	Smaller and younger businesses, as well as businesses owned by less wealthy individuals, are less likely to be able to provide collateral and guarantees. Increased reliance on collateral without an equal emphasis on information will mean fewer marginal borrowers have access to loans.
Risk-taking (on balance sheet)	
Lenders shift the composition of their assets away from trading.	Other things being equal, more funds become available for lending to businesses, including SMEs
Lenders change the composition of their assets away from riskier borrowers.	Lenders consider SMEs to be riskier borrowers as a segment and would most likely limit the amount
Lenders boost loan-loss provisions based on improved models.	Improved modelling would reduce rationing and increase the amount lent to smaller borrowers, but it is not clear how much further improvement is possible while maintain profitability
Lenders make a point of attracting SME deposits as a more stable source of funding.	Liquidity rules could provide an incentive for banks to substitute wholesale funding for deposits, including SME deposits. Competition for SME deposits could spur competition in SME lending.
Risk-taking (off balance sheet)	
Lenders originate (securitised) loans for specialist SME loan funds, taking SME loans off balance sheet (Schäfer & Jenkins, 2012). Alternatively, lenders become increasingly reliant on government and other guarantors for SME loans	The two approaches are equivalent: most loan guarantee schemes effectively act as means for the guarantors to outsource the origination of loans. This would remove some capital constraints on SME lending, but perverse incentives in origination could lead to bad debt. The creditworthiness of guarantors is likely to come under scrutiny. Small business loan securitisation increases the amount that can effectively be lent to SMEs against the same amount of capital, but bad incentives and standardisation could lead to loss of information.
Control	
Lenders reduce risk through increased use of covenants or reduce risk and funding costs through reduced maturities. This is already an established means of dealing with information asymmetry.	Owner-managers may be less likely to accept covenants. Moreover, longer periods of negotiation for small business loans could redirect some businesses to non-bank or informal lenders.
Changes to the product mix	
Lenders move away from products that consume capital and liquidity.	This is already underway; overdraft lending will come under particular pressure as it ties down

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	expensive capital even if the SME is unwilling to draw on the facility.
Lenders shift their business to primarily fee-based sectors rather than increase margins.	Up-front fees and cross-selling are unpopular among SMEs and might prompt a backlash in terms of demand; large retail banks make less than a third of their small business income from sources other than credit and deposits.

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