Federation of European Accountants
Fédération des Experts comptables Européens

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Dear Madam, dear Sir,

Re: FEE Comments on the European Commission's Green Paper on Long-Term Financing of the European Economy

(1) The Federation of European Accountants (FEE) with number 4713568401-181 of the European Commission's (the Commission) Register of Interest Representatives is pleased to provide you with its comments on the European Commission's Green Paper on the long-term financing of the European economy (the Green Paper).

(2) FEE's represents 45 professional institutes of accountants and auditors from 33 European countries, including all 27 European Union (EU) Member States. It has a combined membership of over 700.000 professional accountants, working in different capacities in public practice, small and big accountancy firms, businesses of all sizes, government and education. Adhering to the fundamental values of their profession – integrity, objectivity, independence, professionalism, competence and confidentiality – they contribute to a more efficient, transparent and sustainable European economy. In representing the profession, FEE recognises the public interest. Therefore, FEE finds it important to address Europe's access to long-term financing in order to fund long-term investment needs that are crucial for its growth.

Support for Green Paper

(3) FEE supports the Commission's initiative to stimulate a debate on how to foster the supply of long-term financing and how to improve and diversify the system of financial intermediation for long-term investment in Europe.

(4) The access to long-term financing is essential for sustainable economic growth in Europe, directly affecting employment, innovation, and competitiveness. Therefore FEE supports the initiative of the European Commission and will be pleased to further contribute its experience and expertise to advance this matter that is critical for Europe's future.

(5) Stimulating long-term investment is a difficult issue that needs to consider many different factors. We therefore welcome the Commission's attempt to take a holistic perspective on this matter and understand that in a short high level consultation paper it is not possible to go in-depth on all aspects. We however note that this important debate could have been even more fruitful and thorough if some of the research to which the Green Paper alludes to would have been explicitly referenced and if the European Commission would have been clear on some of the underlying assumptions apparently made in the Green Paper.

FEE Approach to Responding to the Green Paper

(6) FEE has not answered every consultation question posed, but rather focussed on the five subjects where we believe we can contribute most, based on our areas of experience and expertise. These are: 1) general comments; 2) taxation; 3) accounting principles; 4) information and reporting; and 5) the ease of small and medium-sized companies (SMEs) to access bank and non-bank financing.

GENERAL COMMENTS

Long-term financing requires holistic long-term policymaking

(7) FEE supports the holistic approach taken by the Commission to look at how to foster long-term financing in the EU. Such an approach is necessary because many of the determinants of long-term financing are interrelated. These interrelations can be complex and need to be studied objectively on the basis of an in-depth analysis of facts. A proper debate on such an important issue, and furthermore, policy decisions, should be supported by robust, thorough and objective factual evidence.

(8) FEE would like to emphasize the importance of the predictability and stability of the policy and regulatory framework and of legal certainty in securing an environment conducive to long-term investment.

(9) In identifying sources of short-termism in markets, the Commission should also consider the impact of certain government policies. The financial crisis provided examples of how regulation and policies can have a negative effect, multiple contradictory effects, beneficial and necessary on the one hand, damaging on the other hand or unintended consequences (for instance, policies making equity less attractive, making listing more expensive, requirement for quarterly reporting, capital requirements raising the cost of certain long-term investment for banks...). These aspects should also be taken into account to encourage a long-term focus in policymaking. Proper, thorough, objective and independent impact assessment is a tool that helps identify and mitigates these issues.

(10) It is difficult for investors to take long-term positions and to maintain them if governments frequently chop and change their policies on matters such as taxation, incentives for investment, planning laws, and environmental controls. If governments wish to promote long-term investment, they need to make policy choices that they are prepared to stick with for the long term.

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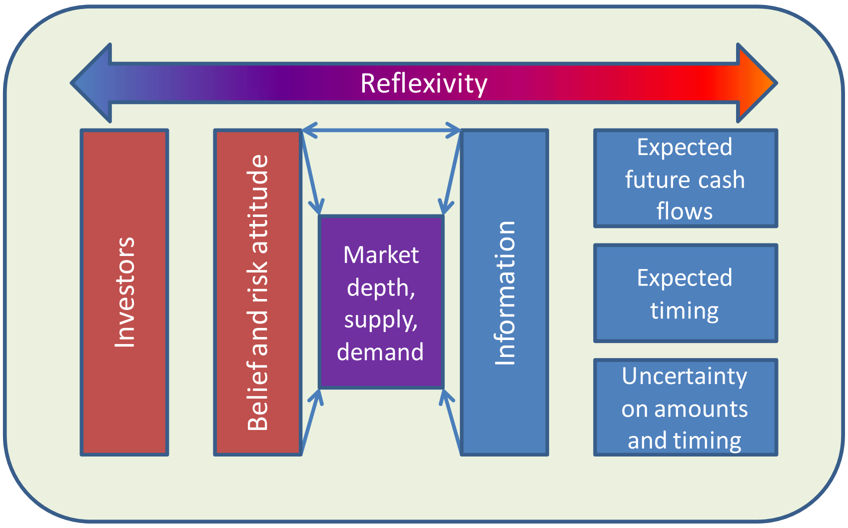
Association Internationale reconnue par Arrêté Royal en date du 30 décembre 1986

Role of institutional investors

(11) FEE confirms the reasons stated in the Green Paper for institutional investors being well suited to provide long-term financing.

(12) It may be important to reflect some of the main factors determining decisions of long-term investors. The *amount*, *timing* and *uncertainty* of future cash flows are perceived as the value determinants of a financial instrument. These are factors that are typically looked at when making a decision of granting a loan (underwriting decision). Amounts of future cash flows may be influenced by government interventions (e.g. by tax policy). Uncertainty of future cash flows may be reduced for the investor by promising fixed cash flows (like in a fixed interest instrument) and backing this promise by e.g. guarantees.

(13) *Investors* have their own degree of *belief* in the relevant information presented to them and have their own *attitude to risk*. Transaction prices include a price for risk (also depending on the particular attitude of the investor) that is based upon the uncertainty of the future cash flows, the funds available and the investment alternatives. The fundamental uncertainty in future cash flows and the way markets price risk on a certain day are different things and have a different meaning for long-term investors; the first is a structural factor while the second is an instant snapshot. Lack of *market depth* may create concerns for investors, because it creates uncertainty as to whether an investment can be sold off at the moment that circumstances change or de-risking becomes required. Deep financial markets are important to bridge the different investment time horizons that different investors have. *Reflexivity* further complicates the picture as stakeholders' behaviour may make future cash flow expectation become untrue (no matter how well-founded they were in fist instance).



(14) Economic theory has identified and debated the issue of time preference very early on. The longer the investment horizon gets, the higher are the risks involved. Therefore public policy needs to focus on incentives, which would make the long-term funding more attractive to investors. It would be beneficial to investigate what information presented by business influences investors' time preference. The value creation process reflected in expected returns usually only answers the “how much” question, but it does not answer the “why” and "how" questions. Integrated reporting (discussed below) may have the potential to connect these questions, thereby enhancing the credibility of long-term investment projects and leading investors to the right choices.

(15) Regulators should be mindful of preserving insurers' ability to invest in long-term instruments. This capacity results from the fact that they have a stable (illiquid) source of financing through the grouping of policyholders. In order to enhance insurers' long-term investment ability, it should be avoided that this source of financing becomes subject to speculation and short term actions by individual policyholders at the detriment of the entire policyholders group.

(16) When investing in long-term instruments, insurers and pension funds usually encounter the following issues:

a. The long-term to maturity of the cash flows is typically something that these undertakings would welcome, because it better matches their long-term liabilities.

b. The lack of liquidity is not necessarily a problem because insurers and pension vehicles can hold instruments to maturity. However, less liquid instruments restrict management actions when portfolios need to be realigned or de-risked and it restricts supervisory intervention. Regulatory (intervention) actions that would encourage and maintain market depth in certain (e.g. securitized) instruments would be likely to give insurers and pension funds more capacity to invest in long-term instruments.

c. Volatility that has two dimensions (that however cannot be distinguished in practice): (a) fundamental volatility in future cash flows linked to the investee which may be reduced by either enhancing the investee's solvency or having an intermediate financing vehicle or a guarantee; (b) market movements linked to investors’ risk attitude and the relation between supply / demand on the market at a particular point in time.

(17) In this respect, an issue that would deserve further investigation would be whether certain disclosures could help investors to better analyse volatility and its different components. The impact that regulators' and supervisors' intervention have on liquidity and their potential procyclical effects should also be further studied.

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Increasing the range of long-term investment instruments

(18) The Commission suggests that a broader range of instruments would enhance the capacity of institutional investors to channel long-term finance. For instance, the establishment of new bond markets or even the creation of instruments beyond the traditional asset classes (equity / bonds) should be further studied. In particular, the potential of such instruments to provide portfolio diversification and stable, inflation-protected cash flows should be further investigated.

(19) To our experience, it seems that the main issue at this time is not necessarily the availability of (more sophisticated) investment vehicles and financial products but the volume of capital made available (and this is particularly sensitive for small and medium-sized enterprises (SMEs)) as well as investor protection. In addition, new instruments, especially hybrid instruments, will automatically introduce an additional layer of complexity and potentially uncertainties as they may generate a new series of questions, for instance regarding their accounting or tax treatment.

(20) Another important consideration in relation to new instruments is the necessity to strike the right balance between the sophistication of instruments and transparency. Lessons of the crisis will have to be kept in mind when advancing on this matter as we have learned that transparency should not be compromised.

Pooled investment vehicles at EU level

(21) FEE in principal supports initiatives on a European level to foster institutional investors' (and others') participation in the long-term financing of the economy. Pooling financial resources and structuring financing packages according to different classes of risk can help institutional investors with diversification and risk spreading. However, FEE stresses that in this case it should be very clear who will perform the underwriting / investment selection function and who bears the economic risk of these decisions. The importance of this issue is demonstrated by the developments in the securitisation market in the period before 2008, where loans were underwritten by banks and subsequently securitised without significant retention of default risks by those banks. As a consequence, there was an unacceptable information asymmetry between those responsible for the underwriting decisions and those who bore the economic risk. This asymmetry should be avoided when creating pooled investment vehicles on a European level that are suitable for insurance and pension undertakings to invest in.

(22) In improving access to long-term financing, FEE also supports other EU initiatives, such as the ones aimed at mobilising more long-term household savings at European level as suggested in the Green Paper. The different models and features of such a European savings vehicle should be further investigated specified and impact assessed as its potential seems worthwhile. It may both stimulate households' savings and help aggregating resources to be invested in European projects and public goods. In addition, enabling citizens to commit their savings to European long-term and socially responsible objectives may also have other benefits for an EU that has no taxing and borrowing powers.

Taxation

(23) In addition to raising revenue, the structure and level of taxation also have an impact on investment and savings decisions and therefore on growth. However, the use of taxation to influence behaviour – which would be the case for investment and savings decisions in long-term financing – is controversial as a neutral tax system may be seen as a better guarantee of an undistorted and effective allocation of resources by markets – that is in the absence of market failures or other externalities and markets distortions.

(24) Overall, tax systems that would be fair, simple, coherent, stable and efficient would make good governance in tax matters easier, reduce the opportunities for tax fraud and contribute to sustainable finance. Given the EU initiatives to promote good governance in tax matters and fight against tax fraud, any suggestions regarding tax measures to promote long-term financing should be carefully considered ensuring that policy goals are not contradictory. It should also be kept in mind that in competing for long-term foreign investment on global financial markets, the EU is the highest tax zone of the world.[1]

(25) Tax incentives could be counterproductive, as they are deemed to make tax systems more complex due to exemptions or additional rules and increase administrative burdens. Additionally, although taxation is not harmonised across the EU (apart from VAT), there are a number of EU Directives in place that aim at the approximation of national tax laws where they directly affect the establishment or functioning of the internal market (Savings Tax Directive, Parents-Subsidiary Directive etc.). These achievements should not be impeded by tax measures aiming at an enhancement of long-term financing.

(26) As far as corporate tax is concerned, the further progress of the Commission's proposal in the enhanced cooperation process should be monitored before addressing any specific measures in this area regarding long-term financing.

(27) Within the EU, tax incentives may also have potential to distort competition and trade between Member States. When exceeding the de minimis thresholds, they may even qualify as state aid. Nevertheless, as stated in the Green Paper, a tax subsidy might be justified when the social return on an investment is higher than the private return of the investor therefore investment levels are below the social optimum. Therefore, tax incentives for innovative projects, e.g. sustainable energy and in research and development could be promoted maybe subject to impact assessment and regular evaluation.

(28) Overall, under the current Treaty on the Functioning of the EU, there is very limited space for harmonised tax measures including if they only aim at enhancing long-term financing in the EU.

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[1] See Taxation trends in the European Union 2013 http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2013/report.pdf: In 2011, the overall tax ratio amounted to 38,8 % of EU-27 GDP, more than 40 % above the levels recorded in the US and Japan.

(29) Nevertheless, the Commission could collect and promote good practices from Member States, provided that these practices are carefully analysed under the above mentioned aspects of fair and simple taxation and the relevant policy goals as well as their compliance with the fundamental freedoms in the EU.

Accounting principles – fair value debate

(30) When discussing accounting matters in particular, the Green Paper is not always clear on a number of concepts and implicit assumptions as well as the viewpoint it takes (i.e. measurement of assets in the investor's portfolio or measurement of assets of target companies). More elaboration and detailed references to studies and research underlying some of the points made would have enabled a clearer and more informative debate.

(31) The accounting basis, whether fair value or historical cost, has an impact on investment choices. It should be outlined that financial information at current valuation is always useful, including for long-term investors. Even long-term investors cannot afford to ignore short-term fluctuations. It would therefore be wrong to assume that in practice there is a total disconnect between short, medium and longer term and valuation at market prices. Fair value namely also provides essential information in reaching a long-term objective.

(32) Information on current valuation of long-term investment should therefore be provided. It is a different issue to ask whether fair value accounting should be used for measurement purposes in financial statements. To our views, fair value should be used if it is coherent with the business model. Fair value accounting is relevant in the balance sheet, depending on the business model, it may not be as relevant for the profit and loss statement.

(33) It should be reminded that the current use of fair value is already limited to instances where it provides more useful information than historical cost. This is mostly in the financial industry, where market prices for financial instruments reflect the current conditions and facilitate their trading on a relatively frequent basis. FEE finds that the use of fair value accounting should not be further restricted, because fair value provides better and more useful information than historical cost, even for long-term investment purposes. Therefore FEE supports the notion in the Green Paper that applying fair value accounting can make financial information more transparent and consistent for investors as it reflects current market conditions. Other than these obvious benefits, the Green Paper suggests that fair value can hinder stability and the long-term financing horizon.

(34) First the Green Paper suggests that the introduction of fair value accounting causes a shift from equity to bonds by institutional investors. FEE is not aware of any convincing empirical evidence supporting this statement. The only example provided of such potential effect, namely the investments by defined benefit pension schemes in the UK and the US, was not conclusive.

(35) Secondly, the Green Paper suggests that fair value accounting encourages an increase in risk exposure by long-term investors, if the volatility is recognised outside their profit and loss accounts. FEE is also not aware of any empirical research underlying this assumption.

(36) In any case FEE would suggest being very careful on conclusions drawn on the possible influences of the use of fair value on stability and long-term financing and to have due regards for empirical evidence.

(37) The pros and cons of fair value and cost accounting have been the subject of ongoing international debate. The discussion on fair value's suitability for long-term investment is equally not new. It should be reminded that studies have not identified a negative role played by fair value in the financial crisis; in particular, regarding instability, the majority of academic research concluded fair value accounting was not a major volatility cause; the enhanced transparency provided by fair value even contributed to an early identification of problems[2].

INFORMATION AND REPORTING

Benefits of reporting

(38) Reporting plays an instrumental role in facilitating access to finance and reducing cost of capital – this is also particularly relevant for SMEs where information asymmetries between manager (owner) and capital providers and creditors can be much higher. Reporting is critical to transparency. It facilitates stakeholders' information, investors' and creditors' protection, market stability, the reduction of transaction costs and the cost of capital. It enhances trust amongst market participants and stakeholders.

(39) It is important that reporting requirements are relevant and proportionate. FEE has always been supportive of proposals aimed at better regulation and simplification. Measures seeking to reduce excessive and unnecessary administrative burdens have a significant role to play in increasing productivity and promoting entrepreneurship, especially for SMEs. However, in order to achieve real benefits for companies and society, in our view, the simplification objective needs to be meaningful and balanced with other public policy goals such as the ones mentioned above. It appears necessary to restate that accounting and auditing are not "administrative burdens" but essential tools to enable managers to manage, investors to invest and enterprises to trade, grow and create wealth and employment; accounting and auditing also have a public interest dimension by contributing to improving the functioning of markets and enhancing corporate governance, transparency and stability.

2 See for example Thomas J. Linsmeier (*2011*) Financial Reporting and Financial Crises: The Case for Measuring Financial Instruments at Fair Value in the Financial Statements. Accounting Horizons: June 2011, Vol. 25, No. 2, pp. 409-417

Quarterly reporting

(40) Many voices amongst business and investors around major capital markets in the world have called for curbing what has been coined as "quarterly capitalism" to indicate the negative short-term focused effect of mandatory quarterly reporting[3]. While transparency remains critical and it is important that business disclose as soon as possible developments or circumstances having a major impact on their situation, performance or prospects, mandatory quarterly reports may lead to more short-term thinking and possibly negatively impact long-term investment and management practices. It may also represent a significant cost for companies.

(41) We believe that the effect of mandatory quarterly reporting should be further impact assessed to provide empirical evidence as to whether or not it incentivises investors or management to (overly) focus on the short term; on this basis the EU and its Member States could consider prohibiting or mandating such a requirement or letting market forces decide.

Integrated reporting

(42) In today's world, historical financial information alone is insufficient to inform investors on a business' capacity and prospects to create value on the longer term. Therefore, FEE supports the work on sustainability and on environmental, social and governance (ESG) reporting and closely follows and encourages continued innovation in reporting both on European as on in international level. FEE supports increased integration of financial and non-financial information as it is critical to bridge the gap between financial performance and the wider context.

(43) In this respect, the most promising development is the growing trend towards integrated reporting[4]. The broad picture sketched by integrated reporting may be especially beneficial in supporting the information needs of long-term investors. With the more holistic perspective it provides and the integrated thinking it fosters, integrated reporting can also contribute to resolving current trust issues on financial markets.

(44) As stated above integrated reporting is currently in development. One of its most interesting features is actually its development model largely drawing on its pilot project and stakeholders' involvement. Therefore it is not time to hinder such promising evolution and stifle innovation by legislating on the matter and imposing mandatory requirements. Integrated reporting should continue to be market driven – at least for the time being – and we would strongly recommend making sure its use is possible and encouraging its development.

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[3] See e.g. Al Gore and David Blood: A Manifesto for Sustainable Capitalism.

[4] Integrated reporting brings financial, governance, environmental and social reporting as well as management reporting into a consistent framework. An integrated report communicates how an organization creates value over the short, medium and long term. See http://www.fee.be/index.php?option=com_content&view=article&id=1055&Itemid=106&lang=en and www.theiirc.org/

THE EASE OF SMES TO ACCESS BANK AND NON-BANK FINANCING

(45) SMEs’ access to finance is particularly critical, especially in the current climate. In this respect, it is important to highlight what is said above regarding the importance of reporting for SMEs' access to finance. The challenges of SMEs to access funding for their growth have become even more apparent since the 2008 financial crisis. Given SMEs' potential to contribute to long-term economic growth, addressing these difficulties is crucial.

(46) FEE has been very supportive of the Commission on its initiatives to address this issue based on its 2011 Action plan. Where possible, FEE has aimed at supporting or cooperating with the Commission on this important public interest issue. FEE applauds the work that has been done in setting up programs for SMEs (such as Programme for the Competitiveness of enterprises and SMEs (COSME) and Horizon 2020), and making those more accessible for SMEs. FEE appreciates this long-term holistic approach including legislative action, financial instruments and policies and involving a wide range of stakeholders.

(47) FEE considers reducing the information asymmetry between lenders and SMEs a crucial factor in increasing the prospects for SMEs of accessing funds. The following two ways could be further investigated to reduce this information asymmetry, namely EU standards for credit scoring assessment and credit mediation by professional accountants.

(48) **EU Standards for credit scoring assessment:** In order for information asymmetries to be reduced, the EU institutions should encourage the production and publication of accurate historic and prospective accounting data for SMEs. This would facilitate banks, other finance providers and credit rating mechanisms to obtain reliable information that can be easily interpreted. Developing standards for credit scoring assessments of SMEs could help address the lack of reliable information about SMEs and the related difficulty for potential investors in evaluating their credit worthiness. Developing common minimum quality standards on external evaluation of mid-caps and SMEs could further facilitate their access to finance, including across borders, and deepen market integration.

(49) **Credit mediation:** FEE thinks that raising awareness on the benefits of credit mediation could really advance SMEs’ access to funding. Professional accountants are uniquely equipped to support their SME clients in this regard. They can advise SMEs on the range of financial instruments available to them and assist them in adequately presenting the SME’s requests to the potential lender. Mediation works best in an environment of disclosure where objective evaluation is possible and universally trusted, as already discussed above.

'Non-traditional' sources of finance

(50) FEE finds innovation an important element in developing sustainable funding of SMEs.[5] Therefore FEE encourages exploring 'non-traditional' sources of finance with a clear assessment of their risks and benefits, especially considering their potential long-term effects.

(51) The lack of a harmonized regulatory and policy framework for upcoming practices, such as crowd funding, deserves attention. Different tax laws, for example, significantly hinder cross-border investment. FEE would recommend the Commission to investigate best practices in this regard, but also the impact on free movement of capital and the need to take legal action. The existing guidelines on microfinance could potentially offer a template for common rules.

(52) On top of well-established practices, such as leasing, and upcoming finance methods, such as crowd funding, FEE would suggest exploring the following sources of funding.

(53) **Securitisation:** Developing new securitisation instruments for SMEs on an EU level, such as through the COSME programme, should take into account the conditions for securitisation, namely that it should be clear who will perform the underwriting / investment selection function and who bears the economic risk of securitisations.

(54) **Equity markets:** Similarly, equity funding to SMEs through the European Investment Fund and the European Regional Development Fund (ERDF) (e.g. for regional venture capital funds) should be further explored in order to provide additional realistic options to smaller businesses. This may have to include a re-evaluation of regulations that unintentionally raise the costs or constrain the availability of funding for SMEs e.g. through second tier stock markets. However, the relative small scale equity funding for SMEs should be taken into account. Currently only around 1% of the European SMEs are acquiring funds by issuing shares on capital markets or by calling on investors. Among the reasons for this are that many equity investors consider the average SME too small to invest and that small companies, can be rather less willing to call on external capital and share decision making power.

(55) In this respect, as stated above, the primary issue is not necessarily the lack of investment vehicles, but the lack of capital available to SMEs.

(56) It is therefore also of utmost importance that the available capital is channelled and allocated efficiently. In this respect and at a time where banks financing is more difficult to obtain, initiatives that can bring SMEs closer to stock markets and help developing markets that are more suitable for this category of enterprises, such as the New York Stock Exchange (NYSE) Euronext Entrepreneurial Exchange project, should be encouraged.

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[5] See also the FEE Roundtable Series „Access to Finance for SMEs – In Search of Innovative Solutions" http://www.fee.be/index.php?option=com_content&view=article&id=878:fee-roundtable-series-access-to-finance-for-smes-in-search-of-innovative-solutions&catid=44:sme-smp&Itemid=179

(57) In this context, a parallel debate has developed as to whether small caps should benefit from a simplified regime; for instance, it has been proposed that International Financial Reporting Standards (IFRS) for SMEs could be used for small listed entities instead of full IFRS. In this respect, it should be kept in mind that the rationale underpinning the requirement to apply (full) IFRS is not the size of the entity but the necessity of transparency for all companies that decide to go public and the imperative of investors' protection. In addition, it should also be reminded that IFRS for SMEs have been developed specifically for companies that have no public accountability. We would therefore conclude that these are two fundamental reasons that make the use of IFRS for SMEs for small listed entities inappropriate.

(58) **Mutual guarantee schemes:** Credit guarantee schemes for small businesses were a significant and successful element of the European response to the downturn of 2008-2009. Countries with a robust tradition of mutual guarantees were able to avoid serious instances of market failure, while those that were embracing this approach could see substantial benefits in the future as trust in the system was being established. Therefore, the EU should continue to promote carefully designed and implemented mutual guarantee schemes in Member States and seek ways to improve liquidity in the secondary market for SME-issued (and often government-backed) securities.

FEE is highly committed to supporting the Commission efforts to foster long-term financing. We therefore remain at your disposal to meet you to further discuss one of the points above or cooperate and contribute our expertise and experience to supporting your objectives in long-term financing.

For further information on this letter, please contact Laura Buijs, Project Manager, at the FEE Secretariat on +32 2 285 40 71 or via e-mail at laura.buijs@fee.be.

Yours sincerely,

André Kilesse
President

Olivier Boutellis-Taft
Chief Executive