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Swedish Authorities' Response to the Green Paper on Long-term financing of the European Economy.

The Swedish Ministry of Finance, Finansinspektionen (the Swedish Financial Supervisory Authority), and Sveriges Riksbank welcome the opportunity to comment on and present a shared view of the Green Paper. We welcome and support the Commission's work on this important matter. Long term finance and its associated challenges is an important issue with regard to the stability of the financial system and the economic well-being of the EU as a whole, and carries with it complex regulatory questions.

Comments and answers to particular questions are provided with reference to the enumeration and the particular question in the Green Paper. If a question or topic has not been commented or answered, that should not be taken to constitute our approval or dismissal. Capitalised terms and abbreviations used in the Green Paper will have the same meaning when used in this response. When used herein, 'we', should be considered as the common view of the Ministry of Finance, Finansinspektionen, and Sveriges Riksbank.

We underline the importance that any potential proposals and initiatives originating from this consultation need to be flexible and adjustable to changes in, for example, market conditions, new financial instruments, and future changes to the legislation. Long term finance initiatives can have significant effects on, for instance, the real economy, the EU-budget and the developments in shadow banking, and are likely to differ between both markets and Member States. Hence, before any initiatives are taken it is crucial to first analyse the actual needs and differences across member states as well as the consequences for financial stability and consumer protection.

1) *Do you agree with the analysis out above regarding the supply and characteristics of long-term financing?*

Long-term financing is a global phenomenon. It is, therefore, in our view important that initiatives, including legislative ones, have a global approach with international consistency. Further, we would like to emphasise the need for increased transparency and better knowledge of the long-term financing issues within the EU. We would also like to stress the importance of thorough impact analyses of the consequences, especially for financial stability and consumer protection, of any proposed initiatives. The principle of proportionality must at all times be adhered to.

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

We do not have a specific view on whether a definition of long-term financing is necessary nor how it should be defined. However, since long-term financing is discussed globally, for example within G20, any definition chosen by the EU should be consistent with international definitions. Additionally, because of its scope the expression "long-term financing" or any similar terms should only be used for discussion and not referred to in legislations.

3) *Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?*

As a consequence of the crisis the role of the banks has changed and will continue to change, also in respect of long-term financing and investment. We believe that banks with their expertise and knowledge will continue to have an important role to play for long-term investments and SME finance, for instance in their traditional role as intermediaries. With this in mind, it is important that new and forthcoming banking regulation is not weakened with the simple motive of allowing banks to engage to a higher extent in long-term financing.

A healthy and stable financial sector is a prerequisite for increased long-term financing and any impact from weakened regulation on the real economy needs to be fully assessed, including the impact on financial stability and consumer protection. It is important to remember that the objective of the new capital and liquidity requirements in Basel III is to address banks' dependence on short-term funding and insufficient levels of capital to withstand losses on their exposures. Thus, these requirements will increase their resilience and capacity to withstand losses and, thereby, reduce the risk of a new banking crisis.

4) *How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?*

In our view, it is essential to respect the principles of sound fiscal budgeting and financial markets' ability to effectively and transparently allocate capital, and to set clear limits on the burden carried by European tax-payers. European long-term financing requirements should not be addressed with financial instruments guaranteed by the EU budget, neither explicitly nor implicitly. Such guarantees may i) increase the budget's risk exposure, ii) distort incentives for the private sector or capital markets' investments, and iii) undermine long-run fiscal discipline by creating possibilities for implicit public lending.

Any financial instruments implemented by governments should be required to satisfy strict criteria such as evidence of market-failure and low risk of crowding out effects on private initiatives. Furthermore, potential instruments should also maintain restrictive leverage ratios, a high degree of disclosure, and demonstrate a positive contribution to the society. Ensuring proper monitoring of such instruments, and both ex-ante and ex-post evaluation, is crucial as previous experiences indicate the lack of legal framework for instruments under the EU-budget and limited knowledge of their market impact.

Multilateral development banks (MDBs) can best support long-term investments by maximizing the impact of existing resources and should only invest in projects with a high value added and where they neither crowd out nor compete with private financing. Rather they should act to complement private financing and help to catalyse additional financing. Cooperation and coordination among national and multilateral development banks is in this case crucial. Furthermore, it should be investigated how extensive the allocation of capital to current funds is, including funds with specific purposes such as regional development and SME finance funds.

6) *To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?*

Due to the higher risk involved in long-term investments, mainly in terms of illiquidity and valuation risks, institutions which hold large volumes of excess capital or have predictable liability cash flows, such as insurers and pension funds, are the most suitable to increase allocations to long-term financing. To support this development it is, in our view, important to maintain a transparent, objective and stable regulatory framework for such institutions rather than compromising on prudent principles (see also question 7).

There are, however, certain opposing developments acting against increased investments in long-term financing by institutional investors. One such development is that the product portfolios of life insurers and pension providers have moved towards defined contribution and unit-linked types of products where the policyholder bears the investment risk and therefore also increases his/her influence over the investment allocation. This development may introduce a more short-term view, making long-term investments more difficult. However, this development can also contribute to increased financial stability.

7) *How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?*

We do not believe that prudential objectives should be balanced against the desire to support long-term financing and growth, especially when such prudential rules are designed and implemented. The rationale for such prudential rules and their objectives is to protect policyholders and other beneficiaries. Even though they also may benefit from the formation of long-lived capital, such investments should not be made at the expense of reduced consumer protection.

Furthermore, if the regulatory framework is not seen as prudential, the increased uncertainty of its objectives may lead to further risk aversion and loss of confidence in the financial sector. We believe that the best way to support long-term financing, while not compromising the prudential objectives, is to make certain that legislation is transparent and built upon objective principles. If regulation is allowed to be compromised by too many ad-hoc solutions it can risk the legitimacy of such legislation, its institutions and investor confidence. Additionally, regulators should not take an active and politically motivated role by altering valuation or capital requirements to steer investments in a given direction.

8) *What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?*

We believe that an increasing amount of pooled investment vehicles could stimulate long-term financing within the EU. Therefore, the benefits of having frameworks or platforms at the EU level for these vehicles should be considered. One possibility that should be explored is to develop pooled investment vehicles (long-term investment funds), both for professional and non-professional investors, where regulation for professional investors' funds is, as in AIFMD, not as strict as the one for non-professional investors. Irrespective of the type of investors there should be requirements, as in AIFMD, for these vehicles on disclosure and transparency as well as limitations on their leverage ratios and reliance on short-term funding if they are leveraged. Otherwise, these vehicles may become the kind of *shadow banking* that poses systemic risks.

However, long-term investment funds for retail (non-professional) investors should not be included in the UCITS context. Introducing new types of products into the UCITS classification, especially when it is difficult to ascertain the characteristics of these products and what additional risks they may entail compared to current UCITS products, is not an advisable solution (for an expanded view please see our common reply to *The Consultation on Undertakings for Collective Investment in Transferable Securities (UCITS) - Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments (November 2012)*).

9) *What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?*

We would prefer that larger corporations, who are more compatible with the requirements of the bond markets, to a higher extent finance their debt with corporate bonds so that banks can focus more on, for instance, financing of SMEs. Otherwise, we do not have any proposals for new instruments to enhance the capacity of banks and institutional investors to channel long-term finance.

However, before introducing any new instruments they need to be thoroughly assessed from a financial stability and a consumer protection perspective. For example, such instruments should not cause a phenomena or behaviour that has a negative impact on the financial system, e.g. certain kinds of shadow banking. In addition, for these new instruments there should be high requirements on transparency and disclosure.

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?*

We do not believe that the cumulative impacts of the different current and forthcoming regulations can be assessed at this time as there is still great uncertainty about the forthcoming regulations such as Solvency II. It is important to bear in mind that the current decrease in demand for long-term investments is to a great extent due to the financial crisis and not an effect of new prudential legislation. On the contrary, the new banking regulation is necessary to restore the trust in the financial system within the EU and thereby to reinvigorate the market for long-term investments. In addition, we stress the importance of not diminishing or weakening any of the current or forthcoming financial stability and consumer protection regulations for the sake of increasing long-term investments before performing a complete impact analysis of such changes in the regulations.

Further, we have made certain observations about the impact of prudential reforms. The Riksbank has studied the long-term effect of increasing capital requirements for banks in the report *"Appropriate capital ratio in major Swedish banks – an economic analysis"* (December 2011). The report concludes that there are positive welfare effects for Sweden in terms of higher GDP when Swedish banks maintain high capital levels. This also holds for capital levels well above those proposed in Basel III. In addition, the report concludes that higher capital levels should reduce the banks' (pro-) cyclical behaviour.

In January 2013, Sweden implemented in its banking regulation the LCR requirement based on the December 2010 agreement of the Basel Committee on Banking supervision (BCBS). Note that this version of LCR is much stricter than the one decided by BCBS in January 2013. So far the Swedish experience of this implementation is that it has not affected the real economy or lending to non-financial companies significantly, if at all.

11) *How could capital market financing of long-term investment be improved in Europe?*

We believe that an exclusive focus on the conditions for long-term financing can skew the debate on the broad developments in financial markets. It is rarely appropriate to reserve certain types of financing for specific types of purposes, especially if done to counteract the impact of financial market regulation. Instead, regulators should take the efficient flow of capital from savers to investments into account when initially designing regulation (see question 10.)

That said there are measures that can be used – or, as the case may be, not used – to support the functioning of capital markets. An example of an initiative in the latter category is the current proposal of an enhanced cooperation for a financial transaction tax (FTT), which, in our view, will have a negative impact on the efficiency of financial markets in EU as a whole, including long-term investments. Another important issue is that regulations for the capital markets and other financial markets within the EU take into consideration the special features for different well-functioning markets, for example if the market is order or quote (market-maker) driven.

12) *How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?*

To increase the willingness to invest in equity for start-up ventures, mature firms and market offerings to the financial markets and, thereby, reduce the equity gap we believe that one alternative that could be considered is to increase the use of dual-class voting rights. This could be relevant for firms that wish to retain consolidated control but today choose not to go public for fear of losing such control.

13) *What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?*

The covered bond market, where the underlying collateral is primarily residential mortgages and public sector claims, is an important and reliable funding source for many European banks including the Swedish banks. Any disruption in this market may thus have a negative effect on financial stability. Disruptions may for example occur if investor confidence erodes as a result of ambiguities and gaps in the regulations that affect them. Therefore, we welcome all initiatives that make the covered bond market more efficient, transparent and robust.

It is important that any harmonisation initiatives do not damage or weaken existing well-working operational frameworks for covered bonds. Any weakening could have negative impact on the financial stability and increase the risk of contagion between different covered bond markets. In addition, a complete harmonisation of all rules relevant to covered bonds would be very intrusive to existing national legislations.

We, therefore, advocate evaluating the private initiative of the European Covered Bond Council (ECBC) before possibly proceeding with harmonisation in the EU. The initiative of the ECBC is primarily aimed at identifying common minimum criteria for what constitutes a covered bond, and not to make rules which will make covered bonds identical across countries. However, given the harmonisation issues discussed above, setting minimum criteria could prove to be the best and only solution for a harmonised framework for EU covered bonds. In addition, we believe that the European Banking Authority (EBA) should consider whether it is appropriate to issue guidelines or recommendations regarding harmonisation of EU covered bonds.

One possible issue on harmonisation is to find a common definition for what qualifies as underlying collateral for a covered bond. As covered bonds with primarily residential mortgages as collateral have proven to be robust during financial distress, we see it as important that their robustness and reputation is not threatened. Such a threat could come from the entrance of more innovative covered bonds, for example with SME-loans or other relatively more risky assets in the cover pools.

Covered bonds with underlying collateral in SME-loans, in contrast to for example mortgages and loans to shipping, could contain little or no claimable assets in the event of bankruptcy. This makes such bonds more complex and risky than current covered bonds primarily backed by residential mortgages or public sector claims. We believe that introducing covered bonds with SME loans would potentially lead to a decrease of investors' confidence for all covered bonds - especially in periods of stress. Thus, in our opinion, allowing such covered bonds would have negative implications for financial stability and make it more difficult to agree on a harmonised EU framework.

We do not currently see a need to impose any strict (quantitative) regulation of covered bonds regarding overcollateralization (OC) across the EU, or a cap of how much of a bank's liability side that may consist of covered bonds.

14) How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?

We agree with the Green Paper in that revitalisation of the securitisation markets could have a positive impact on long-term investments. Securitisation in its original form, i.e. unleveraged and based on true sales on the part of the originating institution, could provide useful tools to shift assets to balance sheets of institutions that require smaller capital and liquidity buffers, as it did in the past.

The Swedish market for securitisation instruments is limited; instead the market for covered bonds, with collateral consisting of primarily mortgage loans, is large. However, we believe that some collateral classes, such as SME loans, are not suited for covered bonds but could be included in other forms of securitisation. To improve the securitisation market and limit these assets' possible impact on financial stability, we believe that instruments and collateral have to be standardised, non-complex, e.g. not leveraged, and there has to be a high degree of disclosure and transparency. We, therefore, welcome the current work by IOSCO and FSB on this issue.

In addition, capital and similar requirements for such instruments and banks' exposure to them should be conservative and restrictive to find the right balance from a financial stability perspective. This is especially important when dividing the credit risk between different tranches as the model risk increases.

15) *What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?*

We see no reason for such saving schemes on a national level, hence we see no reason to consider introducing them at the EU level. Moreover, offering higher rates on such saving schemes, directly or via tax concessions, is an implicit subsidy and we believe that the state would benefit more by promoting regular funding instruments such as government bonds.

Households have their own long-term investment cycle that must be taken into consideration. Driving relatively young households to save in long-term schemes that tie up funds may encourage them to incur larger debts to satisfy other life-cycle related objectives, such as borrowing to purchase a home. Such adjustments can be partly rational, reflecting the expectation that the assets they have put aside for future retirement allow them to incur larger debts today.

Since such behaviour effectively implies that households have higher leverage, they become more sensitive to changes in interest rates and asset values. Consequently, allowing households the choice to invest their long-term savings as equity in their own homes should be considered. This line of reasoning also illustrates that it may be inappropriate to look at households' savings as just another source of long-term financing for infrastructure and other beneficial projects.

Forced savings in accounts that are accessible only beyond a certain age also exposes households to greater risks as they may, for instance, be affected by unemployment or poor health. A more general savings buffer can thus offer a higher level of protection than funds locked into long-term accounts. Hence, we have reservations regarding targeted savings accounts, earmarked for long-term investment projects and offering special government guarantees. In addition, we believe that such savings schemes mainly re-allocate savings rather than increase them.

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

In general, we believe that a lower corporate income tax rate would mitigate the distortion between debt and equity and is favourable for growth as this reduces a company's cost of capital, thus making investments more profitable. This, in turn, leads to an increase in the capital stock, productivity and, in the long run, real wages. Thus, in the longer term, lowering the corporate income tax rate should result in increased employment and stronger growth. Lower differences in the tax base between countries also, would in our view, lower the incentives for tax planning.

Possible reforms (e.g. Comprehensive Business Income Tax, (CBIT) and Allowance for Corporate Equity (ACE)) are aiming at reducing the asymmetries between equity and debt capital. In any reform, it is essential to protect the corporate income tax base, advocating simple rules for business, and to prevent evasion.

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?*

Taxing capital gains might cause undesirable lock-in effects that can lead to inefficient capital allocation and counteract incentives for long-term savings. Such lock-in effects can best be exemplified with private pension savings, where savings in private pension schemes are locked-in until retirement. This can have a deterrent effect on other savings.

The Swedish investment savings account allows individuals to re-allocate capital without triggering capital gains taxes on their investments. Furthermore, the Swedish pension system also allows individuals to save for the long run but re-allocate their investments within parts of the system, including investments in mutual funds. This duality creates a mixture of both institutional and private allocation of capital to investments, which encourages long-term savings.

18) *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?*

To avoid distortions and efficiency losses it is important that there is competitive tax neutrality in investments between small and large companies, and between domestic-owned and foreign-owned enterprises. In general a lower corporate income tax rate is preferable to a higher tax with several possibilities for deductions as the latter give incentives for short-term tax planning and investment horizon.

Furthermore, many countries have tax deductions on investments in research and development (R&D) as it has positive effects on economic growth. In Sweden, the government (Ministry of Finance) is preparing a proposal for a possible tax deduction for enterprises investing in R&D.

19) *Would deeper tax coordination in the EU support the financing of long-term investment?*

We believe it is important to have a tax system which prevents tax planning and as a measure against tax planning we therefore support more tax coordination in the EU. Such coordination should contribute to a higher stability and less tax planning which we believe will be positive for long-term investments overall.

20) *To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?*

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise to users making economic decisions. We believe that for regulated entities in the financial sector, fair value accounting is the best option for prudential supervision and market conduct as it brings transparency, comparability, and sets incentives for risk management. If prudential supervision is not based on sound economic valuation principles, then the supervisor may take action against an insolvent undertaking too late, i.e. when run-off or transfer to a third party are no longer feasible options. In Sweden, insurance undertakings and pension funds apply fair value principles to liabilities since 2006, similar to what will be introduced with Solvency II.

We do not consider that the use of fair value accounting principles, compared to historical cost accounting, has led to a more short-sighted behaviour by the investors. Instead, the short-termism is a consequence of low financial strength, mismatch or excessive leverage. Historical cost accounting can also create short-termism, such as management realizing capital gains in order to produce smooth results, creating the impression of stable profits.

We believe that, rather than disabling fair value accounting when the firm is in a weak position, it is preferable to try to limit excessive risk-taking in good times. An example of a policy tool that limits excessive risk-taking is the countercyclical buffer on bank capital.

24) *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?*

Concerning corporate reporting we believe that the current quarterly reporting system is important for reliability and transparency when making investment decisions. We do not see quarterly reporting as the central issue for long-term financing.

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

Although we share the analysis that the importance of alternative sources of finance for SME:s will increase, we would like to stress the importance that the consequences of any new financial instruments or market-platforms are assessed from a consumer and a financial stability perspective (see our reply to question 9 for further discussion).

There is a risk that new instruments may face difficulty to gain long-term trust from investors (without having government guarantees). We believe that it is important to re-establish banks and venture-capital funds as an important source of SME-finance as they have the experience and the monitoring resources required to successfully solve this issue for the long run.

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

We believe that securitisation instruments could be beneficial to ease the financing for SMEs. However, see our response on questions 13 and 14 for our view on how these instruments should be designed.

29) *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?*

When it comes to issues such as crowd-funding, a benchmarking study comparing different legislative developments on how to create confidence for investors, consumers and firms in different member states would be of interest. Further, we believe it is important to evaluate the temporary risk weight discounts and classification changes for SME-loans in CRD IV.

30) *In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of the European economy?*

We believe that the most important current measure for long-term financing of the European economy is to restore the trust in the banking sector within the EU. In our view, a necessary prerequisite for increased long-term financing is a healthy and stable financial sector, and that the most efficient way to achieve this is to recapitalize banks with weak and/or non-transparent balance sheets. In addition, banks and firms that do not have sustainable business models should not be kept going utilising costly measures. Our view is that the measures mentioned above, especially the recapitalizing, will contribute to the long-term financing and economic growth of the European economy as well as increased financial stability and consumer protection.

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