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

This response seeks to point out the lack of discussion on the choice of the European Commission’s identified priority areas. It will argue that the European Commission has chosen the wrong flagship:

There is no genuine economic necessity to introduce policies to ease access to capital markets. The bank–oriented EU and the capital market–oriented US are two different traditions that have operated for over a century. Furthermore, interest rates close to zero and quantitative easing have made access to credit easier than ever. It is the demand for both credit and capital that is low, not the supply: Any increase in investment depends on earning expectations, and businesses are failing to invest sufficiently due to the economic difficulties in the EU. Consequently, securitisation issuance such as that of asset–backed securities (ABS) has also remained low: There are simply not sufficient loans to be repackaged into ABS.
Moreover, securitisations backed by loans for small and medium-sized enterprises (SME loans) are supported by publicly funded guarantees, both in the US and EU. In addition, the Juncker–Plan, the EU investment package for infrastructure financing, mentioned in the Green Paper, puts taxpayers’ money at enormous risk in its offering of new yield opportunities to the financial sector. While the lucrative senior tranches of its securities are offered to private investors, the junior tranches that cushion the impact in case of losses are held by the governments of EU member states. Regarding equity, small companies, if not already self-financed, usually prefer repayable debt to equity. This is because equity entails the disproportionate influence of financial investors on entrepreneurial decisions. Even regarding SMEs in countries such as Greece and Ireland, for whom access to finance is sometimes problematic, development banks will be more suitable for them than investors who treat them as high-risk investments.

The planned capital markets union (CMU) is not as influential on growth and jobs as suggested by the Green Paper, but rather about increasing trade within the financial sector. The securitisation business is a high-yield business, generating fees every time contracts change hands along the capital markets chain.

According to the ECB banking structures report, assets of the market-based credit system in the Euro zone have already more than doubled over the past decade, amounting to €23 trillion in 2014. Short-term securities lending remains huge with roughly €5.5 trillion in Europe alone. The CMU will increase this trade, making the financial system even more leveraged, thus scaling up systemic risk.

3 Regulators shine a light on the banking shadows; Financial Times, 15/10/2014.
The EU Commission must not take financial business responses as representative of the public. One can expect a strong bias in the responses to this consultation as most views will originate from financial businesses, which profit from securities trading and will, unsurprisingly, be in its favour. For policy makers such as parliamentarians, however, it is advisable to not get distracted by a smokescreen project given by the EU Commission, but instead focus on flagships that have a genuine positive impact on the economy and society.

Two key issues for flagships:

Flagship 1) Shadow banking regulation – preventing the next crisis

The key problem is too much lending in the financial sector. Leverage plays a primary role in creating asset bubbles, as seen with housing prices. Leverage often has more of an impact on asset prices than interest rates. Additionally, credit growth is a highly significant predictor of financial crises. The multiple use of securities as collateral and derivatives exacerbate procyclical dynamics.

Fragile lending activities within the financial sector such as the re-pledging of securities as collateral will not be prevented by just making the securitised products more simple, transparent and standardised. It remains vital to decrease these lending activities and not stimulate them further with a CMU. The CMU is inconsistent with the much-needed regulation of shadow banking.4

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The recommendations of the Financial Stability Board such as haircut rules on short-term securities lending are only a modest start. The EU should follow the Canadian example and ban the re-pledging of securities as collateral. Re-securitisation should also be prohibited: Securitisation can be useful up to a point, as savings banks use it to diversify regional risks. However, re-securitisation increases systemic risk and is not necessary for the real economy.

As the value of collateral is subject to cyclical volatility, regulators should focus on leverage cycles and the overstretching of collateral: In the case of overvalued assets, they should curb the permitted value of these assets as collateral. A regulator should, for instance, say: “You cannot loan at two percent down on houses.”\textsuperscript{5} Israel’s experience with home loan limits is already an example the EU could learn from.\textsuperscript{6} Regulating leverage based on loan-to-value ratios (asset-based leverage) rather than according to debt-equity ratios (investor leverage) has the advantage of addressing the intertwined financial system of banks and shadow banking.

Yet, even at the level of extending rules for banks to non-banks is a lot of work. This includes exploring policies for proper capital requirements for funds and appropriately charged deposit insurances for money market funds.

These policies are crucial to avoiding fictitious liquidity and leverage-based asset bubbles. There will be resistance from the financial sector, as decreasing leverage means a decreasing return on equity. However, the real economy and society need sustainable wealth, not permanent fragility.

\textsuperscript{6} Ackerman, Gwen, and Alisa Odenheimer; Fisher battling Israel’s housing bubble: Mortgages; Bloomberg, 31/10/2012, http://www.bloomberg.com/news/articles/2012-10-30/fischer-battling-israel-s-housing-bubble-mortgages.
Flagship 2) Eurobonds – a basic milestone of European integration

Eurobonds would deliver sustainable long-term financing to all EU member states and could fund infrastructure investments, amongst others. They would per se constitute a substantially big and hence liquid cross-border European market. At the same time, contrary to zero bonds like those in Germany, they would offer investment opportunities with an appropriate interest rate payment for institutional and retail investors. Eurobonds would be simple, transparent and standardised. Hence, they will fulfil many of the claims of the CMU.

Eurobonds prevent investors from driving interest rates for single countries up or drawing money back when it is needed most. They allow solvable sovereigns to stay solvable and insolvable sovereigns to get their debt back on a sustainable track. This is key to growth and jobs, since financial turbulence and unsustainable public debt dynamics hinder potential growth. The CMU is silent on Eurobonds; and they are not a high-yield business. Yet, they are vital to European financial integration and financial stability. They deserve to be a flagship. A European financial market without Eurobonds is incomplete.

3) What support can be given to European Long-Term Investment Funds (ELTIFs) to encourage their take up?

To attract more political support, ELTIFs should be confined to appropriate projects and not push schools and hospitals to deliver return, or to put taxpayers' money at risk. We welcome that ELTIFs will only use derivatives to manage currency risks in relation to the assets they hold.
15) How can the EU further develop private equity and venture capital as an alternative source of finance for the economy?

Co-determination by employees must be extended in order to make private equity investments productive and long-term. Private equity funds can undermine long-term investment such as in research and development, because their aim is to increase the profitability only within a certain time horizon of, for example, four years. Likewise, special dividends and high consultancy fees can hamper investment, as they restrict the options available for re-investing corporate profits. Corporate decisions, like capital increases, dismissals and the sale of companies or part of companies must be taken in the framework of co-determination of employees.

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

Eurobonds would offer low-risk investment opportunities with an appropriate interest rate payment for institutional and retail investors. They would be simple, transparent and standardised.
23) Are there mechanisms to improve the functioning and efficiency of markets not covered in this paper, particularly in the areas of equity and bond market functioning and liquidity?

Eurobonds would constitute a substantially big and hence liquid cross-border European market. They can deliver sustainable long-term financing to all EU member states and fund infrastructure investments, amongst others.

25) Do you think that the powers of the European Supervisory Authorities (ESAs) to ensure consistent supervision are sufficient?

No, the powers of the ESAs are insufficient. They will always lag behind because a key driver of new financial instruments is the desire to overcome regulation: Regulations are followed by financial instruments whose main purpose is to avoid the regulation.7

Therefore the high quality securitisation initiative of the EU Commission should turn to a mandatory approval of complex financial instruments and, as well as securitisations, include derivatives. As a burden-shifting device from regulators to the financial sector, approval regulation would cure the informational asymmetries between them. The World Future Council and the EU office of the Friedrich Ebert Foundation have already organised an international workshop with leading experts on this issue.8

30) What barriers are there around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level and through which instruments?

A broad-based financial transaction tax (FTT) covering shares, bonds and derivatives is crucial to real economic business: It can curb fictitious liquidity where excessive trading leads to unpredictable instability. If asset prices become more stable, businesses will need to spend less on protection against volatility, thus freeing up capital for investment.

As EU-wide unanimity is sometimes unattainable, the enhanced cooperation procedure as well as national initiatives for taxation should be welcomed. Regarding the FTT, the issuance principle as proposed by the former European Commission will also increase the tax effectiveness: Whenever a security of a participating country is involved, its trade is taxed wherever it takes place – this would apply to, for example, a French bond traded in London or Singapore. This means that even a regional FTT applies to trades across the globe. If the issuance principle is combined with the residence principle, every transaction involving a customer or a financial institution from a participating country will be taxed as well.
The World Future Council

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