

May 6, 2015

**CNB's opinion and answers to selected questions from the European Commission  
„Green Paper - Building a Capital Markets Union“**

**A. General opinion on the EC consultation paper**

The Czech National Bank (The CNB) welcomes the efforts to lay the groundwork for the development of the European capital market. At the same time, however, it states that it would not be appropriate if the CMU should entail a number of the Commission's further restrictive regulatory measures on the capital market which might, by contrast, hamper capital market development and its efficiency. Too complex and detailed regulation, without a detailed analysis of its effect, may incur very high implementation costs on users and reduce their competitiveness or competitiveness of the entire capital market. According to the CNB, the regulatory environment should stabilise or some areas should be deregulated (e.d. MiFID 2/MiFIR). Any new legislative proposals should not result in reduced requirements for investor protection or requirements in relation to financial market participants' prudent behaviour. In some areas (e.g. standardisation of some products), the main initiative for possible changes should arise from the industry based on suggestions of market participants.

**B. CNB's answers to selected questions of the EC**

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

The CNB perceives the proposal for the establishment of the capital union as a project whose aim is to strengthen to some extent the financing of corporations and long-term projects by means of capital market instruments using long-term resources, in particular pension funds, insurance companies and savers, and so to align more to the US model, to boost consumer and investment demand and to generally improve intermediation in the capital market. Nevertheless, the CNB sees no greater added value in the project. First of all, it must be stated that the EU has already now a large common and very advanced capital market by global relative comparison, represented mainly by exchanges in London or Frankfurt, and the newly proposed concept in no event should replace or be to the detriment of the intermediating role of the banking sector, whose financial situation has improved recently. It can be assumed that the strengthened banking sector will increasingly perform the traditional function of lending to the economy in the near future.

The CNB is aware that a gap between the United States and the EU in the financing of corporations in the EU capital market is of a long-term nature, that such a gap cannot be closed entirely and that some specific features in the functioning of the US financial system

will probably never be transferred to the EU due to historical or cultural habits of the two financial blocs.

From the CNB's perspective, the Commission consultation focuses on further changes in regulation and fails to take into account that the stability of the regulatory framework is significant for capital market developments (activity of market participants). Regulation has recently changed significantly in the areas of banks (CRD IV), insurance companies (Solvency 2), the capital market (MiFID 2) and investment funds (AIFMD, EuSEF, EuVECA, ELTIF), with some changes not in effect yet or Commission implementing measures still under way. The implementation of further regulatory changes, moreover without evaluating the functioning of already adopted regulation, is, among other things in sharp contradiction with the need for a stable environment.

The CNB strongly advises against changing the current regulatory environment and considers it crucial that the Commission also assesses joint impacts of new and existing acts before each change in regulation, or before each new Commission legislative proposal, in order to identify whether these acts can have ultimately negative side effects on market participants. The Commission should also analyse the cumulative impact of legislative acts enacted over the last three years. The overly prescriptive regulatory environment in the EU will lead to an outflow in capital from the EU to competitive financial centres.

The Commission should, based on the industry's experience and an independent high-quality impact study, primarily, identify those priority areas which might affect the most the use of capital market instruments in the EU. The CNB supports measures aimed at improving intermediation and increasing diversification of corporate financing in the economy but does not support unjustified increase in the regulatory burden.

The CNB takes a cautious position on some proposed Commission priorities, most notably in securitisation. A greater involvement of long-term investors and retail in the form of a greater diversification in less used or new capital market instruments, such as ELTIF, will mainly depend on these investors' judgements regarding return on investment relative to the risk they undertake. Aspects such as comparison with investment in other instruments, investor protection, safeguarding adequate access to information, guarantee schemes, the ability to hedge against related risks or to prevent conflict of interest may play a crucial role in their involvement. The CNB considers it inappropriate to prefer a certain type of instrument in sound market competition of other instruments, irrespective of basic prominent factors, such as suitability of regulation and the very causes of the current economic, fiscal and demographic developments in the EU.

The CNB believes that the proposal for the capital union is missing a greater emphasis on deregulation of the capital market as such. On the one hand, the Commission aims to reinforce the economy and employment with the capital union concept, but at the same time it leaves such regulatory proposals in the legislative process which, as we believe, do not help capital market liquidity and subsequently the economy. Typical examples include the financial transaction tax, the structural reform of the banking sector or some MiFID 2 areas.

***Question 2: What further steps around the availability and standardisation of SME credit information could support a deeper market in SME and start-up finance and a wider investor base?***

The CNB believes that the introduction of a single accounting framework for SMEs, including a single structure of SMEs' annual accounts is a necessary pre-requisite for establishing confidence in SME credit information; we regard the use of IFRS as the most appropriate choice, with possibly reduced disclosure requirements, i.e. not to develop a special European accounting framework for SME (for more see answer to question 8). It is hard to imagine that a credible data base of comparable information, used by creditors and

investors, could be built without a single framework for financial information, which would entail e.g. an introduction of uniform methods for the recognition and valuation of SME assets and liabilities including leasing.

**Question 3:** *What support can be given to ELTIFs<sup>1</sup> to encourage their take up?*

The CNB sees no reason for an accelerated take-up of further steps aimed at the functioning of these funds. The most pronounced difference from other investment funds is their focus on investing in projects whose return is on a basis of decades. Owing to the long-term focus of these funds, it is logical that success of such funds (and their legislative regulation) cannot be assessed earlier than at a 5–10-year horizon. ELTIF regulation has not taken effect yet.

The CNB believes that an increase in the number of these funds in the EU does not depend on legislative changes but on investors' willingness to invest available funds in this kind of investment and necessary time for the establishment and development of these funds. This is mainly related to qualitative and quantitative aspects of projects in which these funds invest or to the tax advantageousness of investment in these funds.

**Question 4:** *Is any action by the EU needed to support the development of private placement markets other than supporting market-led efforts to agree common standards?*

The CNB is of the view that the EU's further steps to support the allocation of capital in investment in the form of private placement are not necessary at the moment. Regarding this issue, it is necessary to note the following:

- According to the CNB, the private placement market has sufficient potential for self-regulation as it is made up of professional clients or wealthy natural persons. These entities have sufficient information, experience, knowledge and skills and are also strongly motivated to search profitable investment opportunities and to properly assess the risks they undertake.
- The allocation of capital in investment in the form of private placement is sufficiently regulated by the AIFMD and EuVECA and EuSEF regulations.
- The AIFMD, EuVECA and EuSEF sufficiently boost cross-border investment in EU financial markets by providing the European passport to alternative funds which are managed by management companies incorporated in the EU.

In our opinion, the EU should limit itself to supporting market-motivated efforts to find agreement on common standards for private placement, which may increase transparency in the cross-boarder distribution of alternative investment funds in the EU, and should not limit the room for private placement market participants by introducing further and redundant measures.

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

The major measures which may boost the economy in the euro area and other Member States may include in particular reform of the labour market, public budgets, as well as measures to support competitiveness of the economy, a better tax collection and a number of other measures, such as the adjustment of the education system to the needs of the labour market. A specific form of these reforms depends on a specific economic situation of each Member State and expectations of the public. We regard especially relaxing credit and liquidity risk regulation stemming from the transformation of maturity in order to support small and medium-sized firms and closely unspecified long-term investment as inappropriate measures. A selective relaxation of regulation would namely reduce the ability of the CRD IV/CRR and Solvency II regulatory frameworks to boost financial system stability, create a precedent for

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<sup>1</sup> European Long-Term Investment Funds

other, particular interests motivated by the mitigation of the EU-wide basis for financial regulation and might undermine the financial market's confidence in the stability of EU financial regulation and the respect for market principles in this regulation.

**Question 6:** *Should measures be taken to promote greater liquidity in corporate bond markets, such as standardisation? If so, which measures are needed and can these be achieved by the market, or is regulatory action required?*

The CNB supports appropriate measures taken by the industry to promote greater liquidity in corporate bond markets. The industry has been taking some potentially important steps to increase liquidity in this sector. This includes e.g. a move away from the well-established trading system on a bilateral basis between dealers, or between a dealer and a client, to central order book trading in a regulated market (e.g. NYSE Bonds in the United States). Possible standards of this market segment should come from the industry based on suggestions of market participants and should not be stipulated from above.

**Question 7:** *Is any action by the EU needed to facilitate the development of standardised, transparent and accountable ESG (Environment, Social and Governance) investment, including green bonds, other than supporting the development of guidelines by the market?*

The CNB perceives green bonds as ones of many other capital market instruments which may interest a certain type of investors, such as investors in shares or mutual funds focusing on firms which allegedly make environment-friendly products.

The CNB also perceives that green bonds find their place among investors due mainly to a greater promotion of environmental protection by world politicians and institutions. National development banks or the European Investment Bank and the World Bank are among the largest issuers of these instruments and interest in these bonds is still rising.

Nevertheless, the CNB sees no reason to artificially create specific legislative regulations for this kind of capital market instruments, distorting so beneficial competition. This also applies to social bonds. The CNB considers it appropriate to support the industry's efforts to create guidelines in this market segment, with an emphasis on basic features of investor protection comparable with other types of bonds.

**Question 8:** *Is there value in developing a common EU level accounting standard for small and medium-sized companies listed on MTFs? Should such a standard become a feature of SME Growth Markets? If so, under which conditions?*

The CNB does not share the view expressed in the Green Paper that imposing full IFRS on smaller companies would be a source of additional cost. It is not so in practice. If an SME is not active in financial instruments, is not involved in mergers and acquisitions, is not part of groups etc., so it is a real SME enterprise, IFRS are substantially simplified for SMEs and do not represent a significant burden for SMEs. IFRS are known to investors and investors use them commonly when preparing their investment decisions. By contrast, if an SME uses e.g. derivatives, often changes its structure, etc., it becomes such a large and complex unit that it is desirable for it to use IFRS.

An accounting framework should safeguard that accounting methods are the same for all units as investors need comparable information. A lack of comparability raises considerable concerns and undermines confidence, especially among investment analysts. All major corporate performance indicators are based on comparable financial statements data. The CNB is therefore convinced that it is not desirable to develop IFRS for MTF-quoted SMEs. Seeking and developing a special European accounting framework for SMEs and its subsequent adoption would mainly mean that a factual solution to problems is being postponed without previously securing investors' future interest. At the same time, the

creation of a special European accounting framework for SMEs would mean a complication for third-country investors, for which investment in SMEs, as shown in the Green Paper, should also be attractive. If SMEs use IFRS, they will also be more legible for their trading partners.

**Question 9:** *Are there barriers to the development of appropriately regulated crowdfunding or peer to peer platforms including on a cross border basis? If so, how should they be addressed?*

According to the CNB, crowdfunding and peer-to-peer platforms can be regarded as rather supplementary financial intermediation instruments.

Crowdfunding is currently regulated by multiple EU legal regulations. The CNB believes that this situation is not disadvantageous at all since crowdfunding is not a tight specific activity which could be clearly regulated by a single legal rule.

The CNB is therefore convinced that a single European legal regulation of crowdfunding is not necessary at the moment. The legislation in force enables providers to make passports for crowdfunding services to other Member States. These are, for example, payment service providers (peer-to-peer platforms) or investment firms (investment crowdfunding platforms).

Possible obstacles can be seen in a certain lack of clarity of the link of these platforms to the existing regulatory framework, such as payment services or collective investment. In order to clarify the relationship between crowdfunding activities and EU regulation, an analysis has already been made, and ESMA (investment crowdfunding) and EBA (credit crowdfunding) positions have been published.

A sufficient insolvency framework for resolving borrowers' default is also a necessary pre-requisite (in order to retain attractiveness for investors), but this does not relate specifically to crowdfunding and the peer-to-peer platform only.

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

The CNB believes that the regulatory steps aimed at lower costs are not desirable or necessary, at least not for the Czech Republic. Already today, about 50% of Czech investors' assets, invested in investment funds, are invested in funds with the domicile in another EU Member State. A significant proportion of domestic funds is managed by an entity controlled again from another EU Member State. Thus, no major barriers to the cross-border provision of services in this area can be seen here.

**Question 12:** *Should work on the tailored treatment of infrastructure investments target certain clearly identifiable sub-classes of assets? If so, which of these should the Commission prioritise in future reviews of the prudential rules such as CRD IV/CRR and Solvency II?*

The CNB does not support any reduction in capital requirements for risks arising from holdings of infrastructure assets due only to boosting investment in the economy irrespective of prudential impacts on capitalisation and the solvency position of credit institutions, insurance and reinsurance companies. Capital requirements should capture actual risk stemming from investment in infrastructure assets. The setting of prudential regulation should thus be based on a reliable and proper assessment of these assets. On the one hand, all relevant types of infrastructure assets should be analysed. On the other hand, however, the examination should be limited only to asset classes and sub-classes, whose risks can be properly determined, measures, monitored, managed, checked and reported (see e.g. Article 132 of Solvency II). Insurance companies should not invest at all in infrastructure assets which would not comply with these requirements.

As regards credit institutions, CRR contains a regulation for special sub-categories of corporate exposures within the IRB approach – specialised credit exposures (e.e. project financing). However, the name of these exposures does not imply that they are less risky. The purpose of introducing this category is to measure credit risk of these exposures in a manner which is relevant for them. A possible revision to CRR relating to a decrease in capital requirements under Pillar 1 cannot contribute to greater attractiveness of investment in infrastructure and other long-term projects as the risks stemming from these exposures would have to be additionally covered under Pillar 2 (an introduction of various asset sub-categories would still not reduce the risks associated with these assets).

***Question 14:*** *Would changes to the EuVECA and EuSEF Regulations make it easier for larger EU fund managers to run these types of funds? What other changes if any should be made to increase the number of these types of fund?*

The CNB does not support further changes to the rules relating to activities of the EuSEF and EuVECA. Regulations which govern these types of funds have become effective only recently (April 2013) and implementing legislation has not been adopted yet. According to the CNB, further changes in the regulation of these funds would bring unnecessary legislative uncertainty, which might reduce their attractiveness for managers and investors.

The current regulation of the EUSEF, or EuVECA, imposes a duty on managers of these funds to apply for a licence if a limit of EUR 100 million and EUR 500 million respectively is exceeded. If the licence is granted, these funds may also be offered in other Member States. The CNB believes that the above limits contained in the regulation need not be increased.

The CNB believes that an increase in the number of these funds in the EU does not depend on further legislative changes but rather on investors' willingness to invest available funds in this kind of investment and necessary time for the establishment and development of these funds. This is mainly related to qualitative and quantitative aspects of projects in which these funds invest or to the tax advantageousness of investment in these funds.

***Question 15:*** *How can the EU further develop private equity and venture capital as an alternative source of finance for the economy? In particular, what measures could boost the scale of venture capital funds and enhance the exit opportunities for venture capital investors?*

In our opinion, an inflow of investment in private capital funds and private equity funds does not depend on legislative changes but mainly on investors' willingness to invest available funds in this type of investment. This is mainly related to qualitative and quantitative aspects of projects in which these funds invest or to the tax advantageousness of investment in these funds. The CNB is against further changes to the rules relating to activities of the EuSEF and EuVECA. Regulations which govern these types of funds have become effective only recently (April 2013) and implementing legislation has not been adopted yet. Further changes in the regulation of these funds will bring unnecessary legislative uncertainty, which may reduce their attractiveness for managers and investors.

Exit opportunities depend mainly on the final product of the fund's investment, i.e. the financial situation and profitability of the company in which the fund invested, demand for new technologies and products in whose development the fund invested etc. Exit opportunities depend also on the business cycle. Financial market in the EU, the United States and other countries offer enough opportunities and capital to match the supply of the mentioned final product with the demand and, in an environment of wide global liberalisation of capital flows, we see no serious institutional barriers for realisation of high-quality investment in private capital funds and private equity funds.

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

The CNB states that there remain considerable bottlenecks on the demand side of the credit market and they consist mainly of households' concerns regarding excessive debt, a weak financial condition of some corporations, including small and medium-sized corporations and also the uncertainty surrounding the return on long-term investment, stemming from expected slow growth in the EU economy and its limited ability to generate demand for labour.

The conditions for the credit expansion are improving on the supply side of the credit channel. As shown by the result of the ECB's survey, banks' credit standards eased in 2014 and the availability of loans for small and medium-sized corporations also improved slightly.

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

UCITS have proved successful in the retail segment, which has a positive impact on investment in the cross-border offering of UCITS funds.

In order to increase interest in this investment across borders, no new legislative measures have to be taken. The Commission's efforts should rather concentrate on eliminating intersectoral regulatory arbitrage (insurance vs. capital market) and achieving more equal conditions between UCITS and substitute products (investment life assurance, in particular), via which the end (retail) investor may be exposed to much higher risks amid lower transparency than in the UCITS segment. This should include product, information duties and distribution and also the monitoring of impacts of current PRIIPs regulation.

An increase in the volume of investment in UCITS in cross-border terms might also be fostered by national or European investor education projects.

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

In this area, the CNB sees the largest room in harmonisation of conditions for financial product distribution. Future peer reviews of national supervisory authorities should focus on a substantial decline in, or elimination of the differences in the supervisory practice of national supervisory authorities in the area of distribution. Large differences among supervisory authorities consequently reduce investor protections and undermine so greater integration of the capital market in the EU.

In the light of the CNB's practical experience, we consider it appropriate to draw the Commission's attention to the efforts of some regulated corporations to use the establishment of a branch in another Member States to make supervision of competent supervisory authorities concerned more difficult.

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

We believe that the existing package of regulatory consumer protection rules (MiFID 1 and 2), PRIIPs, IMD2/IDD, PAD, etc.) and also the existing regulatory rules for protection of savings and investment (the introduction of deposit insurance schemes, investor compensation schemes, the requirements regarding the management and control system, management of the conflict of interests, etc.) are a legal basis for increasing a retail client's confidence in the financial market and supporting his determination to invest.

On the other hand, it must be taken into account that investment in the capital market is associated with risks which cannot be eliminated and requires a higher degree of financial literacy. Direct investment by the general public is also limited by disposable income.

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

The US system is more liberal and relatively less overregulated than the European one. Moreover, unlike the United States, the EU, or the European Parliament, has been promoting more populist issues in EU legislation, such as the financial transaction tax, remuneration, regulation of short selling and, overall, regulatory micro-management of all aspects of credit institutions' business, which excessively increases compliance requirements, raises costs and decreased profitability of financial firms. In addition, compliance costs excessively burden smaller financial institutions, reducing thus a sound competitive environment in the financial market and distorting the market. The EU thus creates sometimes unnecessary obstacles to free enterprise in the EU. The excessive and overly prescriptive European regulation will lead to an outflow of capital from the EU to competitive financial centres. The CNB definitely does not consider e.g. the introduction of the financial transaction tax a way of increasing the EU's competitiveness in the world and making investment in the EU more attractive.

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

The CNB is of the view that the single set of rules is too detailed today. This leads to solutions which aim to oblige all but suit nobody in the end. The implementation of detailed rules entails excessive compliance costs for financial institutions and vicariously increases the investors' costs.

Nevertheless, the ESAs' generally available interpretative opinions, which might foster convergence of the rules, provide some room for improvement.

But it should be borne in mind that an entirely consistent set of rules is not possible. Law is never applied fully uniformly across jurisdictions. Legal relationship parties, the academic community and individual courts differ in their interpretations of applicable law. The differences in interpretation can be limited but not prevented.

**Question 25:** *Do you think that the powers of the ESAs to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a capital markets union?*

The CNB is of the opinion that the ESAs' current powers to safeguard convergence in supervision are entirely sufficient. In our opinion, some improvements in supervisory convergence can still be identified based on experience via peer reviews or ESA's on-site visits in individual supervisory authorities, and we expect possible further instruments to be identified and tried in practice. However, we still consider a certain degree of divergence between supervisory procedures and practice to be logical, given the size and local specifics of the capital market in different EU Member State.

As regards ESMA's other direct supervisory powers, the CNB does not support a further transfer of powers from national supervisory authorities, which are responsible for stability of their financial system, to ESMA or another multinational supervisory authority. It must be noted in this context that the Commission does not compare the concept of the capital union to the banking union and we thus presume that the Commission itself excludes a transfer of supervisory powers.

**Question 26:** *Taking into account past experience, are there targeted changes to securities ownership rules that could contribute to more integrated capital markets within the EU?*

The CNB believes that one of the points which might foster capital market integration in the EU is harmonisation of the pursuit of corporate actions (payment of dividends, division of



shares, realisation of options, repurchases, etc.). This issue has already been defined in the 2001 Giovannini Report as Barrier 3 – Differences in national rules relating to corporate actions, beneficial ownership and custody.

It would be appropriate to follow up on the industry's activities in this matter, see e.g. the standards of the European Banking Federation<sup>2</sup>, and the Commission's previous work in Securities Law Legislation.

The removal of legal obstacles and the stemming uncertainty, associated with holdings of securities, might have a positive effect on securities trading and be beneficial to the European financial market, including its increased competitiveness. Ultimately, future legislation will foster a better protection of securities-related rights. An improvement of the legal framework for securities settlement should stimulate competitiveness, contributing thus to greater efficiency of European settlement structures.

The CNB is of the view that if the assumed CMU project is to be indeed effective, it should first of all remove barriers such as non-harmonised securities law, corporate law, insolvency law or insufficient legislation relating to debt restructuring.

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

The search for ways of improving transfers of collateral should wait until the functioning of EMIR and other regulations is assessed, whose aim was to build repo transactions data warehouses, to standardise OTC derivatives margins, etc. Market standardisation in this area can be considered sufficient at the moment (e.g. the frequently used ISDA contracts).

***Question 28:*** *What are the main obstacles to integrated capital markets arising from company law, including corporate governance? Are there targeted measures which could contribute to overcoming them?*

The CNB is aware that it is difficult to set a single correct corporate governance model. However, a deeper capital market might be fostered by harmonising national legislation relating to corporations, including corporate governance.

In order to create uniform rules and procedures under CMU, it will also be necessary to take into account the requirements for harmonisation of legislation relating to securities.

The CNB is of the view that if the assumed CMU project is to be indeed effective, the barriers quoted in the answer to Question 26 would have to be removed first.

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

The CNB does not consider it appropriate and especially realistic to promote any tax harmonisation at the EU-level. Conversely, the CNB sees the draft Directive on the financial transaction (still under discussions) as one of the fundamental barriers. The CNB regards this tax as harmful for both the financial market and the EU economy. We hence suggest draft FTT be withdrawn from discussions among European institutions.

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<sup>2</sup> <http://www.ebf-fbe.eu/european-industry-standards>