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European Commission – DG MARKT
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25 June 2013

Dear Sir/ Madam,

Barclays' response to European Commission (the "Commission") Green Paper: Long-Term Financing of the European Economy (the "Consultation")

Barclays welcomes the opportunity to respond to the Commission's Consultation on Long-Term Financing of the European Economy.

Barclays is a universal bank with a diverse range of customers and clients ranging from SME's to large capitalised companies. Through the breadth of our franchise we are able to provide our customers and clients with solutions to all their financing needs in both traditional bank lending and non-bank lending markets (i.e. raising loans or debt capital from institutional investors in privately placed or publicly traded markets).

In answering the Consultation, we have provided as wide a view as possible of the potential market structures and products in both bank and non-bank markets that need to be considered in order to answer the policy questions asked. In general, we believe that the structures of the non-bank lending market can improve and expect that greater awareness and understanding should lead to increased activity, which will in turn encourage additional investor demand.

Some of our main observations:

- **The role of universal banks**: Universal banks will continue to play a vital role in supporting long term financing, although their role will inevitably change. Universal banks have evolved in response to the product and service requirements of those they serve, and well-run universal banks are able to benefit from their business model. A universal banking model enables banks to respond to specific needs of a continuum of clients of different sizes and sophistication through offering the full range of financial instruments. Universal banks will importantly continue to offer a unique distribution mechanism for finance using their own balance sheet, as well as tapping third party investors, and through their branch networks and existing relationships with institutional investors.
- **Non-bank financing**: It is clear that the needs of the business community cannot be met fully through bank lending. During times of economic growth bank lending is a

highly efficient and accessible form of finance for many companies. At other times however, supply may be constrained. As a result, bank debt can be highly cyclical – contributing to economic contractions. This means it can be an unsuitable tool for financing early stage companies, particularly those invested in innovation rich sectors. Barclays believes that non-bank alternatives must be an equal focus for policy makers to achieve a funding environment as diverse and high quality as small businesses.

- **SMEs:** It is widely recognised that SMEs are the most likely drivers of economic growth, and should be a significant policy focus. Barclays is committed to supporting businesses through responsible lending. In 2012, we provided £44bn in gross new lending to UK households and businesses. Our lending to SMEs has continued to increase against a market decline: Our growth rate of lending to SMEs over the year to October 2012 was 5% higher than the wider market. Although it is clear that bank lending cannot address the totality of the long term financing gap in the EU, these institutions could play a unique role in developing innovative solutions to "distributing" long term non-bank finance. It is clear however that innovation in this space is constrained by current regulation.
- **Infrastructure financing**: Banks will continue to play an active and important role in bringing alternative sources of investment in to this market as they identify financing opportunities that are suitable for the investor bases that banks' distribution capabilities are able to tap. This role is likely only to increase as additional capital requirements will require banks to identify alternative sources of funding.
- **Securitisation**: Regulatory proposals put forth in the Basel Committee on Banking Supervision (BCBS) Securitisation Framework Consultation at the moment pose a real threat to this market. Regulation should not class all securitisations as the same, thereby failing to differentiate between assets, and instead should recognise high quality securitisation from other forms.

If you would like to discuss any aspects of this in further detail please contact Edmund Lakin, Assistant Vice President, Government Relations, (edmund.j.lakin@barclays.com).

Yours sincerely,

Cyrus Ardalan
Vice Chairman, Head of UK and EU Public Policy and Government Relations

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

Broadly speaking Barclays is in agreement with the analysis, and we welcome the current focus of the European Commission towards encouraging sustainable growth. We do feel though it is important to differentiate within the analysis between small and large financing requirements. In Europe, banks' role – and appropriateness - in providing financing for investment differs across the size and type of the borrower, the purpose and structure of that financing, and the geography the transaction is occurring within.

Although it is clear that the current business financing environment is not currently sufficiently diverse to meet the needs of all customers, it is important to distinguish between differing forms of finance, and between the differing needs of customers.

For example, traditional bank lending for SMEs remains effective for those customers who fit within responsible lending criteria, and acceptance rates for these customers have remained high throughout recent years. Additionally, many corporates are able to finance their development requiring debt finance on tenors available in the market.

But it is clear that these two markets cannot address the totality of financing requirements in the EU, and there remain customers who are unable to access finance, or whose ability to access finance is constrained. Much of this demand does not satisfy banks' risk criteria for responsible lending.

For these customers, non-bank finance and equity in particular are fundamentally important alternatives, the design of which are appropriate for their needs and risk profile. Unfortunately, in many instances these sources of finance are not fully accessible.

Barclays believes that this non-bank finance and equity gap is a deeply significant challenge.

It is, therefore, vital to distinguish between "meetable demand" and "non-meetable demand" for finance. The latter represents a market that banks have not traditionally served and are increasingly even less able to serve because of changes in regulation, among other things (see later questions).

"Meetable demand" describes requests for debt finance from customers who meet banks' risk criteria. Where a request for debt finance does not meet these risk criteria, in our experience one of two situations has occurred – either the customer proposition is not viable; or the proposition is best financed through another form of finance – e.g., equity. For those customers who are not a viable proposition for finance, it is often possible to work with them to identify changes which could be made. For the second group, it may be that alternative; non-bank finance is not only more accessible but the better financing option of their needs.

It is clear that in Europe there is a lack of alternative financing options, especially compared to the US. Within the UK, this is particularly true outside of core areas such as the "Golden triangle" of London, Cambridge and Oxford. Some have correctly identified that a disproportionate number of these firms reside in high-growth segments that do not have significant tangible assets or cash flow (e.g., because they are investing significant amounts in R&D or are focused on technology opportunities that are in a pre-revenue position). We believe that these types of firms represent significant long-term economic benefits to the

European economy; but their business models are not typically suited to traditional bank debt finance.

Equity investment is therefore vital as it is structured to absorb the uncertainty associated with volatile (or non-existent) earnings. It represents the type of "patient capital" which many have rightly championed.

We therefore welcome this Consultation as a means of considering equity and other non-bank forms of long term finance to support existing bank finance markets.

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

We see the simplest definition of long-term financing as financing with a maturity over 5 years. Another possibility would be to define it as the useful life of all assets which require financing, which would then capture both development financing and long-term financing.

However, an important distinction is between financing which is designed to match the lifetime of a specific asset, or to provide cash flow, and financing which is designed to absorb significant development, start up or ownership risks.

The latter requirement is best met through equity finance, which does not require a company to have assets against which to secure a loan, or a revenue stream to meet interest repayments. This is particularly material in innovation rich sectors like high technology, which may be pre revenue for a number of years.

We would therefore encourage the Commission to consider the long term finance challenge as a question of the form of risk and opportunity that the finance is designed to support, and whether the "gap" in the EU is principally one of equity risk.

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?

We believe that universal banks will continue to play a vital role in supporting long term financing. Universal banks have evolved in response to the product and service requirements of those they serve: they have diverse client and customer bases which have diverse banking and financial services requirements. Well-run universal banks provide a range of benefits for their customers and for society as a whole. For example, the flexible way in which they can manage their balance sheet and use debt create capital and funding synergies, which permit more expansive lending activity.

Assuming the macro-economic outlook remains unchanged and banking regulation is implemented as currently expected, we believe the role of banks will evolve, depending upon the end "user" of the finance. We provide some examples:

- **Large Cap and Multi National Corporates (collectively "MNCs")** across Europe typically have relatively little reliance on banks for direct finance, with the bond and equity markets representing their primary source of long-term core funding used to finance investment. MNCs may use direct borrowing from banks selectively, for example when engaging in Merger & Acquisition activity or when funding a project on an arm's length basis. However, these are often refinanced in the public bond markets

in due course. MNCs mainly rely on banks for backstop liquidity and working capital lines that may be partially drawn, but which do not form part of a MNC's core investment plans. We believe banks will continue to provide these undrawn facilities and these will increasingly become the dominant form of primary bank exposure to MNCs. From a financing perspective, MNCs predominantly rely on banks as intermediaries to arrange and distribute debt and equity financing to third party investors via the private or public markets. We expect this role to grow as European MNCs increasingly diversify away from direct funding from banks to longer term funding debt via the bond markets.

- For **Small and Medium Enterprises (SMEs)** direct borrowing from banks is the primary source of debt funding for investment. Given the relative accessibility of financing from banks for SMEs versus other sources, and the concerted efforts by banks in some geographies to support local SME investment, we expect banks to continue to play a pivotal role in financing for the SME sector. We also believe there is a role for banks in helping to bring third party investment in to SME lending, which in turn will be used to fund long-term investment at the corporate level. Banks offer a unique distribution mechanism for finance, both through the branch network and existing client relationships and there may be an enhanced role for banks to offer access to equity or equity-like finance in some way. Non-bank investors and online funding platforms are relatively new entrants in to the market and are expected to grow in importance, however, banks will remain the major source of debt financing for investment by SMEs.
- Banks' role in providing long term finance for **investment in infrastructure** and other projects is likely to reduce in the future, as new and planned regulatory requirements such as the amended Basel rules, and structural changes in the UK and EU, heighten costs to banks from both a capital and funding position. This is primarily driven by the long tenor (often 10yrs+) many of these projects require financing for. Banks however are expected to play an active role in bringing alternative sources of investment in to this market as they identify financing opportunities that are suitable for the investor bases that banks' distribution capabilities are able to tap. Institutional investors generally have little risk appetite during the construction period of infrastructure projects and may not typically have the skills or resources to structure the financing, carry out due diligence or monitor the asset in construction. Banks are therefore also expected to have a role in facilitating the provision of institutional long-term financing by providing contingent support, co-lending and/ or monitoring during the construction phase of the project. The pool of infrastructure funds, pension funds and insurers may prove to be an important source of finance, both for traditional long term projects and for financings backed by government guarantees which support long term infrastructure investment.

In addition, we would like to comment on some of the challenges facing banks which may have significant implications for their role in the channelling of financing to long-term investments. The Consultation rightly recognises some of the challenges facing banks in terms of liquidity and structural separation. However, some regulatory changes have not been recognised in the Consultation which would be relevant:

- A more beneficial risk weighting for SME debt to address the capital implications of this economically vital activity;

- The exemption from the CVA volatility capital charge for SMEs (both set out in CRD4/CRR);
- BCBS236 which would significantly increase capital charges for banks holding (and potentially making markets) in securitisations.

In particular, we are concerned that the proposed amendments to the securitisation rules may make it more expensive for banks to hold and trade asset backed securities (including but not limited to ABS of SME loans). Such securities would give smaller firms access (albeit indirectly) to capital markets investors.

Over recent years we have scaled back our involvement in the private equity area as the regulatory capital charges for such positions (at least under the UK implementation of Basel 2) were disproportionately high. It is unclear whether a harmonised EU capital treatment will incentivise a re-entry into this market. Whilst a mature portfolio of such investments would tend to be quite diversified and stable (from a P&L/capital point of view) a newly created portfolio will not be for a period of some years.

The Commission's Consultation also comments on the recent report of the High-level Expert Group (HLEG) on reforming the structure of the EU banking sector. We believe in the value of the long-standing universal banking model in Europe and the value of preserving the opportunity for some institutions to choose to provide a wide range of financial services to customers through such a model. Diversified business models and geographic footprints were a source of stability and provided much needed funding to the economy throughout the crisis and breaking up such banks into separately funded entities will undermine their ability to provide through the cycle services to the European economy.

It is our view that the resilience of banks has been significantly enhanced since the crisis via successive capital and liquidity requirements reforms and will continue to be enhanced as the fundamental review of the trading book by the Basel Committee reaches its conclusion and CRDIV is implemented.

We believe that there is no "one size fits all" solution to a diverse EU banking sector in which banks operate a range of business models. We are concerned that structural restrictions are likely to reduce the efficiency with which financial services can be provided, materially increasing the costs to households and corporates, something which the HLEG also acknowledges in its report.

It also vitally important that structural separation should not cut across the resolvability plans for large banking groups, and the EC should take account of the structural reform initiatives already taking place in Member States, and where these exist.

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?

5) Are there other public policy tools and frameworks that can support the financing of long-term investment?

We choose to answer both questions together.

National and multinational development banks have achieved credibility in the minds of investors and can potentially play an important additive role in supporting initiatives for providing new sources of long term infrastructure finance.

If such banks were to provide partial guarantees (akin to those provided by EIB) or act as sponsors of issuance programmes to finance long-term investment, smaller investors who may not currently have the resources to assess these new instruments could obtain the necessary comfort required to invest.

Over time, it could be expected that these less sophisticated investors would become more confident about using these instruments. This could allow the national and multinational development banks to downscale their participation in such programmes and allocate their resources elsewhere.

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

Institutional investors can play a vital role in providing finance, and infrastructure investment of all types is currently highly sought after by investors, particularly pension funds and insurers. Furthermore, as John Kay observed in his report to the UK Government on the "UK Equity Markets and Long Term Decision Making", institutional investors are also a potential driver of long term decision making among corporates.

While individual investors may have relatively short exposure to a specific company, asset managers and other institutional investors are typically exposed to the same core of investments over a significant time horizon.

The institutional investor is therefore well placed to enhance the quality of long term decision making. It is unclear however whether this potential is being fully realised, or whether institutional investors are fully utilising their influence in the governance of companies.

As an example, the use of proxy voting companies to exercise voting rights and other oversight may in some instances reduce the quality of governance.

We would therefore encourage the Commission to consider whether existing long term investors are being fully utilised for their potential to drive long term thinking in the European corporate sector.

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?

This question is best answered by insurers but we are aware of the barriers they face in investing in long term assets due to the Solvency II regime.

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

Some pooled investment vehicles already exist, and the key to the success of a proposal is to set out product regulation that can add real value and whose rules, such as diversification or redemption limits, are easily understood by investors and providers.

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

It is clear that banks offer a unique distribution mechanism for finance, both through the branch network and existing client relationships. As innovation in non-bank finance develops, there may be an enhanced role for banks to offer access to equity or equity-like finance in some way. We understand non-bank finance to refer to the source of finance rather than the mechanism of distribution.

A live example of the above is the £2.5bn Business Growth Fund (BGF) which was set up in 2011 by 5 banks - Barclays, Lloyds Banking Group, RBS, HSBC and Standard Chartered - following the need from filling in the "equity gap" identified by the 2010 Rowlands Reports.

BGF injects between £2m and £10m growth capital in private businesses typically with a turnover of between £5m and £100m, taking a minority equity stake (minimum 10%) and sitting on the board developing a meaningful partnership with businesses. The Fund has invested in 27 businesses so far and over 150 investment opportunities were referred from Barclays Corporate Banking.

Existing innovations, such as peer-to-peer networks offer a great deal of potential as sources of finance for smaller companies. There is however a deal of uncertainty about the regulatory and investor protections surrounding these markets. We believe that these providers would welcome a confirmed, long term regulatory treatment to deliver long term certainty about compliance costs.

Such certainty may also encourage larger distributors to offer similar services, deepening competition and innovation in these markets.

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?

The Consultation highlights the potential tension between the pursuit of financial regulatory reform in EU and the drive to encourage long term investment by the financial sector. Significant reforms to the capital and liquidity requirements for banks have already been introduced and could have significant implications for the incentives to invest in less liquid instruments. One of our key concerns is that regulators have not undertaken a cumulative impact of the varying proposals, by which they would be tasked with assessing the combined impact of regulation on the financial industry as a whole.

Some observations:

- Prudential banking regulation tends to be rather pro-cyclical as Probability of Default (PD) and Loss Given Default (LGD) typically increase as we move into a downturn. RWAs are also greater for longer-dated instruments. Consequently RWAs could increase at a point that capital bases are under pressure from credit losses. This is

pro-cyclical though could be mitigated by using through-the-cycle (TTC) rather than point-in-time (PIT) measures. The potential release of counter-cyclical capital buffers may mitigate against this though it is unclear as to market perception of the release of these buffers and/or regulatory resistance to the buffers being released.
- A further concern in this area is the proposed move to expected loss (EL) provisioning under IFRS9. This is expected to be based on a 1 year PIT EL and could be more pro-cyclical than the 1 year regulatory EL (let alone the lifetime EL for impaired assets). When accounting EL>regulatory EL the excess "provision miss" would result in a transfer out of CT1 to T2, a lower quality form of capital which is less able to support business activity. Press comment has suggested that the implementation of this accounting standard could result in a multi-billion pound requirement for additional CT1 for the UK banking industry alone.
- The EU has provided some relief for SME lending in CRD4/CRR with reduced risk weightings for SME lending and exemptions from mandatory clearing and CVA capital charges for corporates undertaking hedging activity using derivatives. These are, however, isolated examples. The general trend of ever-higher capital requirements and national regulators applying buffers and floors to risk models results in higher capital requirements for corporate loans held on balance sheet. The proposed revisions to the Basel securitisation framework threaten the ability of banks to gain regulatory relief for securitising loan exposures, investing in securitisation and have the potential to be read across to market making these positions. Given the liquidity preference expressed by many investors the role of banks as market makers for securities is critical.
- Basel regulations have put a pressure on returns on Risk Weighted Assets, which has led banks who have been historical lenders to infrastructure projects to move away from long-term lending and favour mini-perm structures designed to incentivise early refinancing.

Some of these impacts could be addressed in the following ways:

- Regulators could provide relief vs. capital buffers for long term financing to relevant sectors of the economy (in a similar manner to the FSA's relief for lending under the UK's Funding for Lending scheme).
- EBA could undertake a peer review of credit models applied to SME and other corporate portfolios with a view to ensuring an appropriate though not over-conservative calibration is applied throughout the single market.
- The EC could add its voice to the rejection of the proposed Basel Committee revisions to the securitisation framework. The amendments appear to be calibrated from the experience of US sub-prime and there is no intention to differentiate between underlying asset types. Consequently socially responsible securitisations (including Prime Collateralised Securities (PCS) ABS of SME loans) would be penalised.
- Use the observation periods for the Basel III liquidity and leverage changes to ensure that these new requirements are appropriately calibrated. If they appear to be mis-calibrated do not hesitate to seek amendments prior to their full implementation.
- Allow the Basel 2, 2.5 and 3 changes to bed down properly before implementing further regulatory change (e.g. structural separation, Fundamental Review of the Trading Book). It is increasingly difficult to plan for the future or commit to long dated trades whilst there is such a high degree of regulatory uncertainty.

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

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?

We choose to answer these questions together.

While banks have traditionally provided long-term financing, the post-crisis regulatory environment has restricted their ability to do so and capital markets will have to fill the gap created by the growing demand for long-term finance. Capital markets are momentum driven: successful issuances allow companies to raise debt at cheaper levels; and strong market appetite can be demonstrated by an increase number of issuances.

Equally, there is a longer term structural imbalance in the form of long-term finance, with an overreliance on debt finance, with poor access to equity finance, especially for smaller companies. Equity investment is structured to absorb the uncertainty associated with volatile (or non-existent) earnings, offering the potential for capital growth to compensate for the risk profile, and suits the needs of the investee company, allowing upfront capital investment without requiring a revenue stream to pay interest. It is counter-cyclical and equity financiers are incentivised to "follow their money" and support companies during a downturn rather than withdraw their support. For example, during the financial crisis period, over £200 billion was raised in equity finance on the London Stock Exchange alone (from the run on Northern Rock in 2008 to the end of 2010).

Equity finance also represents the type of "patient capital" which the CBI (amongst others) has rightly championed. If the capital markets at the top of the financing chain do not operate effectively for SMEs, earlier stage investors - including business angels and the venture capital community - will have a diminished appetite to invest in SMEs at an earlier stage in their development, thus stifling EU economic growth.

There is a ladder of equity financing for SMEs. Seed capital investors and business angels will seek an exit at the venture capital stage and will then look to liquid growth markets and beyond to realise their own returns. To ensure an efficient funding environment, companies should be able to smoothly transition from one source of finance to the next as their business develops. This is supported by the confidence of each level of investor on their ability to sell their holding at an appropriate stage and reinvest in the next generation of entrepreneurs. Thriving equity markets towards the top of the funding ladder are therefore critical to providing certainty to earlier stage investors of attractive exit opportunities. Encouraging early stage investment therefore requires building vibrant growth markets to "pull" investment and companies up the ladder.

Uncertainty over exit options is incorporated in the price an investor pays for a stock at issue. This is also known as the "liquidity risk premium": the less liquid an asset, the less assurance an investor has over his ability to trade in and out of the investment – as a result the investor demands a higher rate of return therefore increasing a company's cost of capital.

Regulatory barriers reducing issuer and investor access to the capital markets increase the cost of capital for SMEs and should be carefully considered. In this way a degree of sensitivity is required. It is clear that below a certain level of investor protection, capital markets experience investor flight. Therefore the policy goal should be to deliver a full set of protections and controls without introducing unnecessary regulatory costs at no incremental benefit.

Finally, Governments' decisions may also have an impact on the way infrastructure deals are financed. In UK Public Private Partnerships (PPP) for instance, whilst one of the financing options could be for the banks to provide short-term financing to fund the construction period, with bank debt being then refinanced in the capital markets once the asset is built (and therefore attracting institutional investors' money), the Government has ruled out taking any refinancing risk, therefore making it more difficult for the private sector to accept this financing model.

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

Barclays would support moves towards a harmonised covered bond framework which would provide clear standards across the EU community for investors. The Commission notes that it may prove difficult to achieve due to the interdependence between many different pieces of legislation, but at the very least minimum requirements in some of the key areas on which investors focus such as asset eligibility or asset pool monitoring requirements could be envisaged.

It is important though to highlight the relevant limitations of covered bonds versus ABS for example, where covered bonds feature no reduction to risks-weighted assets (RWAs) or lower capital requirement as the assets stay on the balance sheet.

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 support efforts to "reshape" securitisation transactions to unlock sources of finance as it had been a critical tool in facilitating cost-effective credit globally.

We applaud the work undertaken by the EU in CRD 2 to eliminate the problems identified in the recent credit crisis:

- Over-reliance on credit ratings;
- Absence of investor due diligence;
- Poor disclosure of the trade economics; and
- Poor alignment of originator and investor interest.

These measures have been in place for some time now yet other significant jurisdictions are still to implement similar reforms.

We believe that a global market for high quality ABS will be deeper than a purely regional market and hence would suggest that the EU compare similar securitisation regimes with a

view to mutual recognition of (inter alia) originator retention requirements. We also believe the Prime Collateralised Securities (PCS) quality label is an important initiative.

Securitisation should not all be treated as the same, and regulation should not treat all securitisation the same. As we highlighted in our response to Q10 we expressed concern that the Basel proposed changes to the securitisation framework was inappropriate. It appears to be calibrated on US sub-prime and take no account of the significant improvements made to the securitisation market in the EU or of the loss experience of EU-originated deals. The recent QIS showed approximately a 4-5x increase in the level of capital required for securitisation assets and the loss of regulatory relief on most securitisation trades.

Whilst the proposals and QIS have focussed on the banking book there is a significant risk that any increased charges in the banking book will be reflected in the trading book. Basel 2.5/CRD3 harmonised the risk weights for securitisation between banking and trading book to avoid regulatory arbitrage. Re-introducing a significantly different banking book vs. trading book regime appears counter-intuitive. If the changes are applied to the trading book the significantly increased capital charges and onerous nature of the calculation would result in a disincentive for market making in this asset class. This would reduce liquidity and make the assets less attractive for non-bank investors.

We would encourage the EC to voice its opposition to the Basel proposals and reflect the G20 commitment to restarting the securitisation market in an appropriate manner. This should reflect the differing experiences in the EU market and benefit from the advances in securitisation regulation that have already been undertaken.

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?

Savings accounts are designed to reflect the specific needs of each market, taking in to account cultural preferences, taxation and consumer regulation amongst other issues. An EU wide model would therefore not be welcome.

We would however welcome member states emphasising savings schemes which facilitate retail investors in accessing long term high growth opportunities in a risk appropriate way.

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

The two possibilities which are normally put forward by academics in response to this question are either that there could be (i) a reduction in the tax deduction given for interest expense; or (ii) the creation of some sort of deemed deduction in relation to equity. In either case we would expect any change to be accompanied by an offsetting change to the rate of corporate income tax to maintain a consistent level of tax receipts. Option (ii) – a deemed deduction in respect of equity, with a compensating increase in the corporate income tax rate – is likely to be a less distortive change for the banking industry, and potentially for other sectors.

We believe that careful consideration should be given to the banking sector if policymakers wish to pursue the first approach (i.e. a reduction in the tax deductibility of debt). In broad terms, a bank's borrowings fund its lending, and that lending produces taxable interest

income currently. The current position is therefore that the tax deductibility of interest gives consistency of treatment between the bank's income and expenditure. If interest payments were made non-deductible for banks, while banks' interest income remains taxable, the resulting mismatch would create a prohibitive tax cost which would have a direct impact on the supply of and demand for lending in the economy.

Our view is that any change of law of this nature, whether following option (i), (ii), or a different method, should be approached with care given the potential significance, and should be subject to a wide consultation. For businesses operating internationally, consideration also needs to be given to the competitive landscape beyond the EU.

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?

Tax incentives for long-term saving need to produce products that are capable of being easily understood by savers and cost effective to operate. To deliver certainty for savers, any tax incentives should remain in place for the term of the investment. Such stability is also important if savers are to have confidence in other tax incentives for long term saving. Any tax incentive to encourage long-term saving is likely to benefit if some element of flexibility is allowed to the saver, so that changes can be made without losing the applicable tax incentive in cases such as a change in risk appetite or asset allocation, or certain life events which might cause the saver to need unanticipated access to their funds.

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?

It is clear that the tax system in the UK and in other EU countries dis-incentivises long-term investment and equity finance in particular, with measurably detrimental implications for the economy. To use the UK as an example, the tax environment is a disincentive for investment and issuance of equity. While other asset classes such as bonds and cash are only subject to income tax, equities are taxed four times at purchase, dividend, sale, as well as the corporation tax paid on company profits.

In their 2009 study *Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy*, the IMF found that the marginal tax rate on UK equity investment is 20 per cent, compared to minus 28 per cent on debt [1]. Similar disparities are found across the EU.

KPMG's study into the effects of Stamp Duty found that the tax raises the cost of equity capital for UK business by an average of between 7.5 and 9.0 per cent, and for technology companies by between 10 and 13 per cent. It reduces the total value of UK listed companies by over £133 billion and the total amount of UK capital investment by up to £7.5 billion a year [2].

[1] Data from 2005, updated from Devereux et al. (2002), available at www.ifs.org.
[2] KPMG, *Building a sustainable recovery: Rebalancing the economy from debt to equity – a revenue neutral case for the abolition of UK Stamp Duty on shares* (2010).

The IMF goes further, arguing that corporate level tax biases favouring debt finance are likely to have contributed to excessive leveraging and other financial market problems that came to the forefront during the crisis. It argues that "movement towards neutrality would … be seen as desirable even by those who would wish to go further and tilt the playing field against debt"[3].

In their 2011 *Future Champions* report, the Confederation of British Industry argues that the Government must "ensure that any equity investments are attractive by looking at the tax incentives for corporate venturing, and entrepreneurs' relief, as well as the scope for making the costs of equity investments tax deductible on a par with debt investments"[4].

Clearly, it would be important to deal with these imbalances with care, given how embedded are the pricing assumptions which the tax code has created in the structure of the economy. However, it should be a public policy goal to enhance the tax efficiency of equity investment as a mechanism for both addressing economic cyclicality and facilitating access by European businesses to much needed non-bank financing alternatives across the economic cycle.

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

We consider that this will depend on the nature of the measure that is proposed. Cross-border investment within the EU has been supported by measures such as the Parent-Subsidiary Directive, the Mergers Directive, and the Interest and Royalties Directive. However, much tax law is specific to individual member states, which may indicate that national measures are preferable in some cases

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 Consultation cites research that highlights equity valuations can be more volatile than bonds. This is to be expected with respect to the volatility which relates to the risk of non-payment, since equity is more junior to debt in the repayment hierarchy in the event of liquidation, and therefore carries greater risk of non-payment. Also equity holders' returns are generally paid at the discretion of the company whereas debt is contractual in nature. The higher risk that equity holders therefore face compared to bond holders is compensated for by a higher return. However, debt instruments can demonstrate volatile valuations too where they carry a fixed (including zero) rate of interest, especially if they are long dated.

If investors have chosen to reduce their equities exposure due to equities' greater risk of non-payment compared to debt, this is primarily an investment decision based on how well the characteristics of the different instruments match investors' objectives rather than a response to the accounting required for such investments.

[3] IMF, *Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy* (2010)
[4] CBI, *Future Champions* (2011).

It is worth noting that for many equities the calculation of fair value, whilst based on generally accepted valuation techniques, can be a judgmental exercise. This is particularly the case for private equity investments and other equities which are either unquoted, early stage investments and for which there is no comparative market information available. This gives rise to practical difficulties in arriving at a reliable fair value. However, the accounting standards prescribe a hierarchy of valuation inputs used to calculate fair value which prioritises observable information. In addition disclosure requirements identify which investments are most subjective and the sensitivity of the valuations to changing one or more inputs.

An often suggested alternative accounting treatment to fair value is to hold assets at cost, or cost less impairment. However, this is likely to provide less useful information on the performance of the company in selecting investments and managing shareholders' funds. Management can supplement the performance statements with suitable disclosures regarding their investment strategy, the nature of the investments; the long term expected performance of investments and corresponding incentives to make long term investment decisions. The provision of fair value information over time will provide investors an opportunity to hold management to account over the actual performance of the investments.

IAS 39 is the accounting standard which currently applies to listed European companies long term debt and equity holdings. Generally, except for those which are held for trading purposes it requires them to be carried on balance sheet at fair value with gains and losses recorded outside profit and loss within a separate component of equity. Interest and dividend income is recognised in profit and loss. If the investment becomes impaired the loss is recognised directly in profit and loss otherwise any residual fair value change deferred to equity is released on disposal or maturity of the instrument.

IFRS 9 Financial instruments, which is intended to replace IAS 39, is expected to be effective in Europe in either 2016 or 2017 once endorsed by the European Union. We agree with the fundamental measurement principles of IFRS 9, that an entity's reported performance should reflect its business model. Fair value is very often the appropriate measure for financial assets and provides investors with the most transparent and decision-useful information. IFRS 9 requires fair value measurement for equity investments. Long-term debt investment is also permitted to be held at cost – a non-volatile measure – provided the debt is plain vanilla and held in order to earn an interest based return and not for selling. Relatively minor deviations from this expected performance will result in the entire investment being held at fair value with gains and losses being included in profit or loss. Such deviations could include various terms which enable financial institutions to share in the returns from a project, or reduce its risk.

We consider that the accounting currently required under IAS 39 and in future by IFRS 9 provides appropriate and decision useful information in the financial statements and entities certainly have the ability to avoid recording volatility in short-term profitability, as well as explaining their business model, short term performance and long-term strategy. If there is short-termism, we do not believe it has or will be caused by the accounting treatments required or permitted by IFRS.

21) What kind of incentives could help promote better long-term shareholder engagement?

The key to effective shareholder engagement lies in communication between management and shareholders. Shareholders have different investment strategies to suit their needs and their plans.

The Consultation suggests increased voting rights or dividends to long term investors. We would not support incentives to promote one tier of shareholder over the other, as equality of shareholder is an important principle and would encourage public policy to recognise this value. We see the following main problems:

- Discrimination on this basis appears to be undemocratic as may concentrate control within a minority of shareholders, especially in the case of companies who have low free float levels
- If a shareholding loses some or all of its voting rights on sale, it is reasonable to assume that this loss of strategic influence would reduce the value of that shareholding, creating further illiquidity and a reduction in the overall value of the company. This expected loss may be reflected in the primary market for a company's equity.
- Smaller companies, such as those on AIM and ICAP Securities & Derivatives Exchange, tend, in general, to have smaller free float levels than companies in the FTSE100. The loss of voting rights for each part of that free float will therefore have a disproportionate impact on the ability of shareholders to exercise their ownership responsibilities. It would also mean that the economic impact on the cost of capital would affect smaller businesses disproportionately.
- In infrastructure projects, most risks lie during the construction period. Whilst these projects may be financed on a non- or limited-recourse basis, it is fair to say that funders typically rely on shareholders to help manage issues that may arise during construction. All shareholders, whether short- or long-term orientated will have a strong interest in ensuring the project is complete (as this will drive respectively their ability to sell their investment at an attractive price or generate long-term returns). Affecting different voting rights based on shareholder profiles therefore would not seem appropriate.
- Lastly, recent developments in corporate governance practice have encouraged greater transparency and communications with shareholders, and any fragmentation of the shareholding structure could be detrimental to this approach. The practical difficulties in accurate identification of entitlements when shares are acquired and shareholder confusion as to their entitlements, though not insurmountable, are significant.

22) How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?

There is a common assumption that long term investment strategies are inherently more valuable than short term ones, driving higher long term returns as well as broader governance and social benefits.

It is certainly true that long term investors have an important role to play in the market. However, there is an equally important role played by short term shareholders in driving liquidity, which is vital for price certainty and for long-term investors to have confidence that they would be able to exit an investment if needed.

From the perspective of many issuers of equity, liquidity risk is the most significant cost experienced when raising money in the primary market. Investor willingness to support a company is influenced by how certain they are of their ability to sell that investment at a later date. Any uncertainty over exit options is factored in to the price an investor pays for a stock at issue - the "liquidity risk premium". Therefore, the less liquid an asset, the less assurance an investor has over his ability to trade in and out of the investment – as a result the investor demands a higher rate of return therefore increasing the company's cost of capital.

A vibrant market with both long-term and short-term investors is therefore at the heart of both supporting investors in managing their risk, and for businesses in achieving low cost fund raising.

As has been noted by the London Stock Exchange and others, shareholder turnover is not the right metric to describe investor time horizons, because it reflects the increased speed with which a portion of the share base is traded, rather than the size of that portion as a proportion of the overall equity. In other words, the increasing speed of HFT strategies, rather than an increase in the amount of shares being traded according those strategies, has resulted in a low average holding period. As an example, London Stock Exchange analysis of company share registers shows that, in 2011, 83 per cent of investors turned their portfolio over less than once every two years, which does not indicate significant loss of long term investors from the market.

Barclays, therefore, believes that it is more appropriate to consider whether the current investor engagement model is effective, and not seek to focus introduce incentives for short-term focus. The Consultation may wish to consider in more detail whether there are governance concerns about the increased use of agencies and proxy advisors (we are aware that the Commission is looking at this area in the context of the revision of the shareholders' rights Directive).

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

As the Commission will be aware the Kay review was published in the UK – "UK Equity Markets and Long Term Decision Making". The report highlighted a number concerns about how fiduciary duties were interpreted in the context of investment. In particular some stakeholders felt:

- It was not clear who in the investment chain was subject to fiduciary duties and what those duties were;
- Their fiduciary duties required them to maximise returns over a short-term scale, precluding consideration of long-term factors which might impact on company performance; and
- Their obligations were entirely defined and limited to their contractual obligations or required no more than a duty of care.

One recommendation of the Kay review was for the Law Commission to review the legal concept of fiduciary duty as applied to investment. The Law Commission is expected to publish a final report in June 2014. We see that there could be benefit in reviewing the legal concept of fiduciary duty to clarify the kind of fiduciary treatment expected of asset managers and wait with interest for the Law Commission's review.

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?

Transparency of information provided to investors is at the heart of an effective relationship between shareholders and the companies in which they invest, and Barclays puts significant effort in to ensuring that the information it discloses is clear, timely and accurate. We believe integrated reporting has an important role to play in improving the quality and completeness of corporate disclosure, and will be of benefit to a range of stakeholders. We view non-financial key performance indicators as fundamental to measuring a company's long-term success, and as such, Barclays has committed to publishing an annual balanced scorecard of both financial and non-financial measures.

We are in favour of integrated reporting where this serves to foster transparency and reduce duplication, and welcome its potential role in integrating the strategy of businesses with their long term goals. We believe that it can be achieved without creating any additional legal requirements.

We consider that a robust framework already exists, and further requirements will soon be published, for the disclosure of non-financial information in the UK in the form of the requirements for a Business Review. This combined with the SEC requirements that already apply to companies that are US registrants, result in management reports that are comprehensive and include a wealth of information about strategic objectives and how the entity is delivering on its longer term goals. The EU should consider any additions to this framework in terms of cost benefit and also adding to the overall length (and hence transparency) of financial reports.

The UK guidance mandates the disclosure of key performance indicators, but leaves the choice of such indicators to management, to enable them to select indicators that are most relevant to understanding the companies' strategy and performance. We believe that this is appropriate and that such metrics should not be mandated.

We observe that the overall trend is towards, not away from, quarterly reporting for larger companies (especially those with a US listing) which is driven by investor demand more than actual requirements. Many UK companies with no such requirement provide investors with quarterly information that is becoming far more comprehensive. It is certainly possible therefore that quarterly reporting will be a permanent feature of European corporate reporting.

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

The key benchmarks which companies provide and investors monitor vary by industry but are generally well established. For example with regard to banks they include:

- Return on equity, preferably adjusted to remove one-off items and thereby present a representative trend over time of business performance
- Cost income ratio, also adjusted as described above
- Core Tier 1 ratio, under Basel 2.5 and pro forma calculation under Basel 3
- Net Tangible asset value

As highlighted above, Barclays has also committed to publishing an annual balanced scorecard of both financial and non-financial measures. As such, we consider it is important for benchmarks to evolve over time and reflect changing market conditions and investors' information needs, which sometimes change quickly. For banks for example, the current economic environment has resulted in greater interest in benchmarks such as the cost income ratio and capital ratios which are widely reported and commented upon. We are concerned that mandatory benchmarks would not be suitably responsive to investors' changing needs.

These and other benchmarks are calculated by reference to a point in time, e.g. balance sheet date, or a reporting period such as a quarter, half year or full year. Such widely used benchmarks tend not to extend over longer periods of time such as 2 or 5 years. However we consider the value of benchmarks to be greatest where they are used to identify or illustrate a performance trend over time or to highlight a risk and how the risk is being managed. This can provide an indication of how the business has developed and provides an indication of longer term performance and risk management. We therefore do not consider that any specific steps should be taken at this stage to develop additional long term performance benchmarks.

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

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

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

29) Would an EU regulatory framework help or hinder the development of this alternative non-bank source of finance for SMEs? What reforms could help support their continued growth?

We choose to answer these questions together.

The Commission is right in this Consultation to look at improving access to non-bank debt. Barclays are focused on developing a funding environment able to support the ambitions of businesses of all sizes and sectors.

We have significant experience in lending to and supporting small and medium sized businesses. Our position as a universal bank means we are well placed to explore ways to supplement this bank lending by developing access to capital markets, new sources of investment and creative, non-bank funding streams.

As the market for non-bank finance grows and develops, there is the potential for greater familiarity and critical mass to facilitate a reduction in the minimum deal sizes in which it is economic for investors to assess. However, it is likely within the traditional capital markets that these minimum deal sizes will still be large (in the region of about £20m+ in the debt markets for example), due to the professional fees and compliance costs associated with issuance. These markets are likely to remain inaccessible for many smaller mid-sized

corporates in their own right, including those whose turnover is in the lower part of the mid-cap bracket.

Given that investors will generally aspire to develop a diversified portfolio of mid-sized corporate exposures, it may be possible to reduce minimum deal sizes for issuers with the use of intermediating vehicles and structures to pool issuers.

There are examples of bond fund pooling in Austria which makes it viable for investors and issuers by allowing investors to access pooled risk and allowing issuers to access the bond market even for small volumes of lending. Timing is important in this respect - structured financings are currently challenging given the current very weak appetite for structured debt compared with a few years ago.

UK SMEs and mid-sized businesses require a diverse range of funding options, as well as efficient and cost effective banking finance. Barclays continues to be committed to delivering this service. We also believe that there is significant opportunity for enhancing the role of the equity funding ladder in absorbing early stage and development risks.

From our own experience as a provider of business funding and from our discussions with industry and business organisations, we believe the Commission should approach the non-bank challenge by recognising the need to develop funding diversity.

SME and Mid-Cap Bond Markets

The 2010 launch of the London Stock Exchange's ORB retail bond market provides a good illustration of how the correct infrastructure can promote liquidity and volumes of a 'new' product, buy introducing a new pool of capital. The wholesale bond market historically excluded the vast majority of retail investors by virtue of minimum denomination requirements of £50K+ - sums of capital which retail investors do not typically have access to. The launch of the ORB presented a standardised platform for this pool of investors with far lower minimum denominations, and has proved an effective primary market. There is early evidence that issuers may be able to achieve smaller scale fundraising than on the wholesale markets.

Private Placements

The private placement regime is a viable alternative for corporates wishing to raise funds without accessing the capital markets. As private placements are illiquid securities, the underwriting process requires greater due-diligence to be performed on the issuer followed by stricter credit committee scrutiny. Once a deal has been originated by the company and its advisors and is bought by the investor, the investor needs to continue to monitor the performance to the issuer. All of this requires greater man-power and typically dedicated teams to look at the asset class. Improvements to the structure of the market could enable more institutions to develop this capability and therefore, the EU private placement market could become deeper and more liquid. This improves momentum and critical mass of the market. Importantly the development of a standard set of measures for the EU private placement market could be considered. We propose below some basic parameters. We see that these could be utilised for evaluating credit metrics and analysis for institutional investors to use when calculating regulatory capital, as well as enabling regulators to evaluate and benchmark accordingly:

1. **Liquidity**: Liquidity is an important part of determining a company's ability to sustain itself and thus is integral in helping make a credit quality assessment. Rating agencies rank companies using a scale of liquidity. In most cases for an assessment of investment grade, liquidity must score at the higher end of the range of rankings. Liquidity testing transcends industries and thus can be a good tool to use for a company in isolation rather than relative to a peer group or industry average.
2. **Volatility**: Volatility is another area of focus for both investors and rating agencies when assessing credit quality. Volatility can affect all aspects of issuer from credit metrics, covenants, business profile to profitability. Many banks and investors who assess unrated issuers typically will use volatility measuring tools which focus on earnings or share price movements. This analysis is used as a supplement to the fundamental credit underwriting process and can vary depending on how data is used particularly for private companies
3. **Credit Metric Ratio Analysis**: Ratio analysis should form a foundational view on credit quality of issuers. There are many ways to evaluate a company's financial statements and every investor and rating agency will have different views on appropriate ratios based on the industry a company operates within. In general, we feel some form of cash flow test based on leverage as well as a cash flow coverage test could serve as a useful starting point.

"Shaving bonds"

There are examples of companies successfully issuing non-transferable and non-convertible investment products to retail investors in accessible lots of £1,000. These products can be more cost effective than retail bonds for the smallest issuers, as they do not attract the same level of disclosure requirements. However, this relative lack of investor protections may prevent their development into a mainstream investment option for high street savers. We believe that these products could develop to become a viable capital-raising option for companies wishing to raise similar amounts.

Peer-to-peer

Peer-to-peer lending is a growing sector. Organisations such as Funding Circle offer entrepreneurs and businesses a means of pooling and therefore, diversifying credit to be lent to peers. This model may reduce transaction costs. However, to date, its principle advantage has been to offer access for borrowers who have been rejected by traditional funding routes.

Although this mechanism reduces the transaction costs associated with bank lending, it also removes the risk management skills. It may be suitable as an alternative funding mechanism for micro-businesses and the smallest SMEs. Barclays would, however, encourage the Commission and the peer-to-peer sector to work in partnership to find means of delivering quality risk management processes to ensure this sector is able to perform strongly in the long term.

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?

In this submission, Barclays has identified a number of constraints to traditional bank finance, notably responsible risk management and regulatory requirements, which prevent traditional lending from wholly addressing the funding gap experienced by European businesses.

However, it should be possible to make use of the scale and reach that the banking sector offers to address non-bank sources of finance. Barclays believes that innovation in this space could transform the funding environment for SMEs and even enhance the traditional lending markets by providing an equity underpinning. This may be through platforms or other mechanisms which bring together potential investors and growth businesses to facilitate equity and other non-bank investment, whether further supported by traditional bank finance or not.

However, it is clear that the current regulatory environment would make such innovation difficult, and Barclays would welcome serious consideration of the value of developing regulatory structures to allow innovative new non-bank finance platforms, whether operated by new entrants, or through existing providers. We would welcome further discussions with the Commission on this point.