EU Commission's Proposal for A Regulation on Structural Measures Improving the Resilience of EU Credit Institutions

Position Paper

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This position paper summarises the point of view of German non-financial companies on the EU Commission's proposal on Structural Measures Improving the Resilience of EU Credit Institutions.

Deutsches Aktieninstitut (DAI)[1] and Bundesverband der Deutschen Industrie (BDI)[2] have contributed several times to the debate on structural reform in order bring to the attention of legislators the general point of view of the companies of the real economy on structural reform of the EU banking system.[3]

General Comments

Non-financial companies certainly are interested in a financial market regulation that addresses systemic risks appropriately and thus ensures that non-financial companies are provided with financial services in a reliable manner. Companies of the real economy have therefore been generally supportive to the strengthening of the capital requirements for banks in particular.

However, we doubt that far reaching changes to the existing banking structures as proposed by the EU Commission will improve systemic stability and properly address the "too big to fail"-problem. To the contrary we believe that the substantial interference will create an additional burden for credit institutions and their non-financial customers und will contradict parts of other regulations already enacted (in particular EMIR, see below).

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1 Deutsches Aktieninstitut represents the entire German economy interested in the capital markets. Its about 200 members are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt am Main, Brussels and Berlin.

2 Bundesverband der Deutschen Industrie e.V. (BDI, www.bdi.eu) is the umbrella organisation of German industry and industry-related service providers. It represents 38 industrial sector federations and has 15 regional offices in the German Länder. BDI speaks for more than 100,000 private enterprises – 98 % small and medium sized – employing around 8 million people. Membership is voluntary.

3 See Deutsches Aktieninstitut, Die Debatte um die Spaltung von Universalbanken, 13 March 2013, Deutsches Aktieninstitut/Bundesverband der Deutschen Industrie, Comment on the EU Commission's Consultation Paper on Reforming the Structure of the EU Banking Sector, 9 July 2013

From our point of view it has been proven neither theoretically nor empirically that the system of universal banking has serious flaws and the separation of trading activities and/or the prohibition of proprietary trading will increase the resilience of the financial system. The proposal will make banking structures as well as the relationship with the customer more complex and thus more costly for both the bank and the non-financial company. In addition to that, the proposal neglects that a number of macroprudential and microprudential regulations is already in force or will shortly come into force. Thus, the additional benefit of a separation of banking activities will be rather small (if there is any). However, the costs and uncertainties created for long-term business relations and established contractual structures will certainly be significant.

The negative impact on the real economy will be the bigger the more lines of business will have to be separated and backed individually by regulatory capital and liquidity. As bank capital and liquidity are scarce any separation of activities will reduce banks' function as intermediaries. Thus, non-financial companies are basically interested in keeping universal banking one-stop services as far as possible. Universal banking allows considerable cost savings and an efficient use of bank capital and liquidity, from which the real economy benefits significantly. For example it is common practice that a bank defines a global credit/counterparty limit for the non-financial customer which is then split into limits for different business lines (e.g. derivative positions, credit facilities, or short term financing needs). The definition of the global limit does not only take into account the potential risks from the different lines of business but also diversification effects on the side of the bank. This kind of calculation will not be possible anymore if banks have to transfer certain lines of business to separate units. Also, the bank will lose flexibility to reallocate a certain portion of the limit from one business line to another if necessary. If every single sub-limit has to be sized to meet peak demand within this business line the total credit commitment will have to be increased significantly. Even though not fully utilized, the higher commitment results in higher capital charges for the banks. As a consequence the forced separation will make it either more costly for corporate end users to be provided with the same counterparty limits or the limits will simply be reduced. The latter is even more detrimental for SMEs which heavily rely on bank funding and often have no alternative access to the capital markets. In both cases the core benefit of the universal banking system will be thwarted at the expense of the end user.

The basic concern with regard to the level and efficiency of bank intermediation holds true for any structural reform measure. Therefore, BDI and Deutsches Aktieninstitut have already expressed their concerns regarding the German law on separation of banking as well as the recommendations of the Report of the European Commission's High-level Expert Group on Bank Structural Reform (Liikanen Report). However, the German law on structural reform includes some elements that at least limit the impact of a separation of banking businesses on the real economy.

Unfortunately, this is not true for the EU Commission's proposal. In particular, we would like to point to four specific aspects of the proposal that are likely to create serious negative impact for the real economy.

(1) Competent authorities discretion (Art. 9, 10 and 13)

According to Art. 9, 10 and 13 the supervisory authorities' have the discretion to demand the separation of certain banking activities in addition to the general ban of proprietary trading. We do not oppose such supervisory authorities' discretion per se, provided it would be properly defined and properly justified. Indeed, the German law on banking structure also already knows such a supervisory option.

However, we are concerned that the EU Commission's proposal will result in the de facto obligation for competent authorities to split banks. At least it will create high hurdles for competent authorities not to use their discretionary power. This is because the bank has to prove that the authorities' reasons for transferring a certain line of business to a separate unit are not justified. Also, the proposal is rather broad with respect to both the assets/trading activities of banks (Art. 3), and the definition of trading activities (Art. 8).
It is therefore likely that many of the main European banks will be split into a core credit institution and a trading unit as a result of authorities' discretion. This again will create negative consequences for the hedging of business risks for non-financial companies as it is explained in detail below.

(2) Art. 11 and Art. 12: De facto prohibition of risk management services to non-financial customers for core banks.

The most important concern relates to Art. 11 and 12 of the proposal. Both Articles will strongly limit the core banks' ability to provide non-financial customers with risk management services and thus contradict EMIR and the recommendations of the Liikanen Group (see below). We expect that Art. 11 und 12 will become relevant for all main European banks because the proposal makes it far more likely that bigger European banking institutions will be split subject to the competent authorities' discretion.

More specifically, the core credit institution's risk management services for non-financial customers (Art 12) as well as the own risk management instruments (Art. 11) will be limited to "derivatives eligible for central counterparty clearing".

This is only a subset of the whole range of derivatives used in the corporate risk management process. In particular, non-financial customers frequently use OTC derivatives that are not eligible for clearing. Important examples are F/X derivatives, which due to their often very short-term nature do not make reasonable clearing candidates. They mainly contain settlement risk, which is better mitigated by the existing settlement platform of the CLS bank. In addition to that, derivatives used by corporates are regularly tailor-made as an effective hedge requires that the terms of the risk mitigating derivative exactly reflect the characteristics of the underlying business. As a result such bespoke derivatives are neither standardised nor liquid which also makes them less attractive and less suitable for central clearing.

Last but not least, the new clearing infrastructure is just about to be set up which creates a high level of uncertainty which derivatives will be considered as eligible for clearing by the competent authorities. Furthermore, clearing standards are likely to change over time and after experience will have been gained. This could result in less flexible standards for clearable derivatives. Therefore clearable derivatives which might appear suitable for the needs of non-financials today may not do so tomorrow. A negative example is the CDS market, where standardisation has been driven to an extent that the product's usefulness for hedging purposes of non-financials nowadays is very limited.

Thus, **Art. 12 will directly prohibit the provision of risk management services to non-financial companies**, unless the EU Commission expressly permits the use of OTC derivatives not eligible for clearing according to Art. 12 (2) a). Even worse, pursuant to Art. 12 the banks' derivative business with non-financial customers will require a certain proportion of the own funds requirements as specified by the EU Commission, so that even the provision of "derivatives eligible for clearing" will be limited to a certain extent. Thus, Art. 12 is stricter than EMIR which does not limit the banks' options with respect to risk management services for their clients.

In addition to that **Art. 11 limits the core credit institutions own options to hedge risks stemming from services to non-financial companies with other banks**. This is also stricter than EMIR. Under EMIR, banks are not restricted in concluding non-cleared derivative contracts provided they pose collateral. Consequently, even though the EU Commission permitted the provision of non-cleared OTC contracts to customers using the discretion of Art. 12 (2) a) the core credit institution would not be able to hedge financial risks resulting from such customer business.

In addition, Art. 11 und Art. 12 do not cover the full range of derivatives in terms of possible underlyings. E.g., core credit institutions will not be allowed to use commodity derivatives or inflation rate derivatives at all pursuant to Art. 11, because such derivatives are not covered by the wording. Thus, they will not be able to hedge any commodity price risk stemming from business with end users.

Thus, a negative feedback loop will be created: If a bank is unable to hedge certain risks from services to clients, it will not offer the services at all.

Overall, Art. 11 and 12 de facto ban hedging services provided by core credit institutions. If a banking group decides to maintain this line of business it will have to be provided through the trading entity. This effect contradicts the Liikanen Group which recommends that the „provision of hedging services to non-banking clients"[4] should remain in the deposit taking core bank.

	Non-Financial customers hedging needs	**Derivatives that banks will be permitted to offer to non-financial customers according to Art. 12**		**Derivatives that banks will be permitted to use for own hedging purposes according to Art. 11**	
		Banks under EMIR/CRD IV	Core credit institution under the Proposal	Banks under EMIR/CRD IV	Core credit institution under the Proposal
Bilateral OTC contracts (not eligible for clearing) without bilateral collateralization	Frequently used for hedging of commercial and treasury financing risks	Yes	No	No	No
Bilateral OTC contracts (not eligible for clearing) with bilateral collateralization	Bilateral collateralization is rather the exception because of huge amount of liquid funds needed	Yes	No	Yes	No
Derivatives eligible for clearing/Exchange traded derivatives	Used rather infrequently	Yes	Yes	Yes	Yes
		Shaded areas: Proposal is stricter than EMIR			

Table: Limitations to hedging services arising from Art. 11 und 12 compared to EMIR/CRD IV

The forced separation of hedging services will lead to a substantial increase in hedging costs and/or decrease in hedging volumes for non-financial customers for several reasons.

First, the business relationship of non-financial companies with banks will become more complex which will increase transaction costs and most likely lead to a renegotiation of contracts (e.g. ISDA Master Agreement) with all main banks in Europe at the same time. During the EMIR implementation phase non-financial companies have made the experience that even partial amendments of these contracts take a lot of time and demand a substantial commitment of resources.

4 See High-level Expert Group on reforming the structure of the EU banking sector, Final Report, p. vi and 101.

Second, non-financial companies strongly prefer contracting with the core bank (or the group as a whole) because the group as a whole will regularly have a stronger balance sheet and hence a lower risk profile. In contrast, the trading unit will likely have a weaker balance sheet than the combined bank used to have. As a consequence, the volume of hedging with derivatives will be reduced by the demand side because non-financial companies will reduce their exposure limits for reasons of counterparty risk management. Alternatively the volume may also be reduced from the supply side because the capital of the trading unit may not be sufficient anymore to cover the previous amounts of counterparty risk from derivatives business. The result would be again that non-financials could not engage into all risk management transactions deemed necessary. The bank may also choose to furnish their trading unit with more capital in order to allow risk management services to non-financial customers to remain stable in terms of volume. This however will translate into higher prices for these services which will reduce the demand and thus once more result in a lower hedging activity of non-financial companies.

Overall, Art. 11 and 12 contradict the political agreement and will as expressed in the EMIR and the CRD IV. The political agreement rightly accepts that the derivative business of non-financial companies does not create a systemic risk because derivative contracts are "backed" by the commercial or treasury financing activities of the non-financial company. To the contrary, systemic risk is lowered: non-financial companies enter into OTC derivatives to manage effectively financial risks and to "shield" their core business activities against these risks.

Art. 11 and 12 work in the opposite direction. They will make hedging more costly and/or will directly limit the volume of hedging services offered in the markets. Thus, more financial risks than today will have to be borne by non-financial companies. This transfer of financial market risks to the non-financial sector cannot be in the interest of the EU as it decreases systemic stability.

(3) On proprietary trading and market making

The proposal of the EU Commission prohibits proprietary trading completely. This is also stricter than the recommendation of the Liikanen Group as well as the existing German law on banking structure which only demand to set up a separate trading entity for proprietary trading under the roof of the banking group.

Though it is not the core concern of non-financial companies it should be noted that a ban of proprietary trading is a serious interference with contractual freedom and needs to be carefully analysed. Furthermore, proprietary trading contributes to market liquidity and thus will reduce volatility in market prices. We would therefore prefer if proprietary trading remained possible. Risks that may arise from proprietary trading, in particular with respect to market manipulation, should be and are already addressed by a number of capital market regulations.

Besides this, we read the proposal as it would also create the discretion for competent authorities to separate market making activities. Market making does clearly play a beneficial role for the real economy because it contributes to the liquidity of financing instruments (stocks and bonds) as well as derivative instruments that are used for hedging purposes. As a general rule, market making is the more beneficial the less liquid the respective instruments are. A separation of market making will most likely lead to higher costs for this kind of activity. Deutsches Aktieninstitut und BDI, therefore, strongly recommend that market making services remain in the core credit institution. At least there should be high hurdles of proof for the competent authorities to force a separation.

(4) Potential limits to the interbank market as a source of finance

As stated above the impact of a separation of banking on the real economy will be the bigger the more restricted banks are in their activities.

Against this background Art. 15 and 16 of the proposal also need careful consideration. Art. 15 defines extra-group exposure limits to financial entities for the core credit institution which appear to be stricter than the comparable standards of the Capital Requirements Directive/Regulation. Art. 15 thus has the potential to interfere with the interbank credit market as a means of reallocating funds among different banks which could also affect the ability of banks to provide credit or other services to companies of the real economy. In addition, the EU-COM is empowered to restrict risk mitigation techniques for these credit exposures pursuant to Art. 16. It is unclear what exactly the EU Commission is aiming at with this provision. However, it appears to be clear that any restriction in risk mitigation techniques (such as netting agreements, guarantees) will also translate directly into a lower ability of the core credit institution to enter into the interbank market.

Conclusion

Overall, Deutsches Aktieninstitut and BDI are deeply concerned that the proposal will negatively affect non-financial companies' ability to hedge against financial markets risks in an appropriate and cost-efficient way. Furthermore, other negative unintended consequences on the provision of credit and the reliability of long-term business relations in the universal banking system are likely.

We therefore urge the EU Commission, the European Parliament and the EU Member States to review the proposal in order to avoid any disruptive consequence for the real economy. At least the scope of activities that remains in the core credit institutions needs to be extended to meet the non-financial companies' business needs.

More concrete:

- The core credit institution should be permitted to offer all kind of derivatives to non-financial customers and to use all kind of derivatives for its own hedging purposes. Also, there should be no specific exposure limits for this kind of activity. Art. 11 and 12 therefore need to be redrafted in order not to contradict the achievements and agreements under EMIR and CRD IV with respect to the real economy. It is clearly not sufficient that the Commission *may* permit the core credit institution to use or provide additional derivatives other than those eligible for clearing or to extend the scope to additional underlying not yet covered. It should not be necessary to appeal to the Commission in order to reach consistency with already existing financial market regulations like EMIR.

- Furthermore, the legislator should keep in mind that a separation of banking activities will necessarily create legal uncertainty and interfere with established business relations. The universal banking system cannot be replaced without disruptions of these business relations. Deutsches Aktieninstitut and BDI thus prefer as little interference as possible to avoid unintended consequences for the provision of financial services to non-financial companies. Namely, we strongly recommend market making activities can still be performed by the core credit institution and if proprietary trading will not be completely banned.

Contacts

Deutsches Aktieninstitut e.V.

Dr. Gerrit Fey
Head of Capital Market Affairs
Niedenau 13-19
60325 Frankfurt am Main
T +49 69 92915-41
F +49 69 92915-12
fey@dai.de

Bundesverband der Deutschen Industrie e.V.

Dr. Reinhard Kudiß
Abt. Wirtschafts- und Industriepolitik
Breite Straße 29
10178 Berlin
T +49 30 2028-1422
F +49 30 2028-2422
r.kudiss@bdi.eu