Deutsches Aktieninstitut

Basel IV in the EU

Improving an already well-balanced proposal to reflect better European corporate realities

Position Paper of Deutsches Aktieninstitut on the EU Commission's Banking Package implementing the remaining parts of the Basel III framework, 30 March 2022

Reflecting European Realities

In November 2021, the EU Commission made public the proposal to implement the remaining parts of the Basel III framework into EU legislation (EU Banking Package).[1] The EU Banking Package will certainly also impact non-financial companies.

Non-financial companies organised in Deutsches Aktieninstitut[2] have generally supported the strengthening of bank and capital market regulation in the aftermath of the global financial crisis because systemic stability as well as safe and sound banks are key for allocation of capital and thus growth of the entire economy.

However, we also believe that the regulation of banks – if too strict or inappropriately calibrated – may interfere with the role of banks as intermediaries and risk takers for the economy. Strengthening capital requirements even further as it is intended with implementation of the remaining parts of the Basel III framework (commonly cited as Basel IV) may thus interfere with the ability of banks to provide finance and other services in a sufficient and cost-efficient manner. This might ultimately create risks for the competitiveness of European companies and economies.

Furthermore, it is important that the transposition of the remaining parts of the Basel III framework recognizes the characteristics and realities of the European economies. Otherwise, international harmonisation will lead to a very different impact depending on existing company and financing structures. More specifically:

- The European economies are highly integrated in the global markets for goods and services as well as in global capital markets. The trade-to-GDP ratio in the European Union is 86 percent whereas it is ca. 23 percent in the USA according to world bank data.[3] European exporters and importers thus need reliable and cost-efficient banking services that support their role in the global economy. This is particularly true for the ability of banks

1 EU Commission's proposal on amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor and EU Commission's proposal on amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU.

2 This paper is based on discussions in the corporate finance/corporate treasury working group of Deutsches Aktieninstitut (EU transparency register: 38064081304-25) which is the central forum of opinion building for the treasury departments of the largest German non-financial companies.

3 See World Bank Data set, https://data.worldbank.org/indicator/.

to provide non-financial companies with OTC derivative instruments used to hedge against currency, interest rate and commodity price risks related to operative and treasury financing activities. It also holds true for the field of trade finance, e.g. enabling and securing commercial activities with specific guarantees.

- Furthermore, the role of capital markets as a source of finance is rather limited in continental Europe compared to other regions of the world[4], in particular compared to the USA. Consequently, there is only a rather small number of capital market-oriented companies that already can provide investors and banks with an external rating. In contrast, the vast majority of European companies, even large ones, is unrated. Also this European reality needs to reflected and accomodated in banking regulation in order to avoid negative impact on European companies and economies.

Against this background the EU Commission's proposal includes positive elements recognizing the potential problems resulting for the real economy, but also leaves room for improvement. Though we regard the proposal as good starting point for further discussions, negotiations should aim at balancing the proposal even better while keeping its substance in terms of coping with systemic and bank individual risks.

More specifically Deutsches Aktieninstitut asks for taking into consideration:

1. We strongly support that the proposal maintains the exemption from own funds requirements for derivative exposures with non-financial counterparties regarding the credit valuation adjustment risks (CVA Risk) according to Art. 382 (4) CRR. This CVA exemption has once been introduced in recognizing the specific importance of derivatives for the risk management of non-financial companies and the specific characteristics of the derivative exposures resulting from that fact. Consequently, there has been a broad political understanding not to make the use of OTC derivatives for hedging against currency, interest rate and commodity price risks too expensive or restrict their supply. All of the arguments for that exemption still hold true, so that Commission rightly does not touch this issue.

2. We also support that the proposal temporarily sets the so-called alpha factor at 1 (Art. 465 (4) CRR), which scales up the exposures (and thus the capital requirements) in the standardised approach for counterparty credit

4 See for example the study conducted by Oxera on behalf of the European Commission in the course of the Capital Market Union project, Oxera, Primary and secondary equity markets in the EU, November 2020, p. 21ff., https://www.oxera.com/wp-content/uploads/2020/11/Oxera-study-Primary-and-Secondary-Markets-in-the-EU-Final-Report-EN-1.pdf

risks (SA-CCR). This is also highly relevant for the costs and availability of hedging services as the SA-CCR exposures also define the minimum capital requirements according to the output floor.[5]

However, we are concerned that this measure might be phased out after 2029, as it will be up to EBA to determine the final alpha-factor. From our perspective the EU should better follow the US example and set the factor at 1 for all corporate exposures without any time limit and apply this rule consistently across the CRR given the high degree of international business relations (and thus the high relevance of hedging) for European companies mentioned above.

3. In a similar vein we support that the proposal recognises that capital requirements need to be adjusted to the reality of the high number of unrated corporates among European companies. We therefore support that the EU Commission proposes a transition period: For exposures with non-rated corporates the preferential risk will be fixed at 65 percent until 2032 (Art. 463 (3) CRR). However, as with the transition period for the final adjustment of the alpha factor (see 3.) we believe that already now the time after the transition period should be taken into consideration. We do not believe that it is realistic that for the vast majority of unrated European companies a rating will be available in a cost-efficient and reliable manner. This holds even more true as the rating process entails high costs and lacks the key benefit of getting access to capital markets for those companies. Thus, we are concerned that the cliff effect on the financing costs for unrated corporates will only be postponed but not avoided. This would ultimately mean a competitive disadvantage for European companies vis-à-vis US peers. One option to avoid this is to make the treatment of unrated companies permanent. If this is not feasible it must be regarded as a common political task to make ratings easily available for all relevant companies.

4. We are concerned about potential significant cost increases for widely used trade finance instruments which would most likely make the export business of European companies significantly more expensive. Among the instruments affected are technical guarantees (e.g. advance payment bonds, performance bonds, bid bonds, and warranty bonds). These

5 In an impact assessment conducted by KPMG on behalf of Deutsches Aktieninstitut we were able to show for a sample of 16 big German non-financial companies that additional hedging costs from 112 million to 167 million Euro a year may be expected if no adjustments to the SA-CCR approach had been made. This would have meant a ca. 200 percent increase in costs related to own funds requirements. See Deutsches Aktieninstitut, Basel IV and the Cost of Hedging for Non-Financial Companies, Position Paper of Deutsches Aktieninstitut, 13 December 2019.

instruments are issued by banks on behalf of the sellers of industrial goods and services to secure sellers' contractual obligations towards customers in tenders or contracts in case the seller will not able to deliver the promised good or service after the buyer has paid already a tranche. If a guarantee is granted, a customer may request the bank to pay the obligation in case of seller's default or in case the seller does not meet other contractual obligations. In most cases this is a standard process demanded by buyers, e.g. in public tenders and infrastructure projects, so offering such guarantees is a pre-condition for being accepted as a potential seller.[6]

From the perspective of the bank the guarantee is a conditional, off-balance liability that may or may not arise. Consequently, the seller is charged a kind of an insurance premium. Currently, the so called credit conversion factor of 20 percent for such guarantees is applied for the calculation of risk weighted assets under these contracts. The proposal is about to raise that conversion factor to 50 percent in order to comply with Basel requirements which is due to a reclassification of the relevant instruments into a higher risk bucket (Art. 111 (2) CRR in conjunction with Annex 1). However, this appears not to be well calibrated as experience has shown that historical default rates of these contracts are very small: according to the 2021 ICC Trade Register the obligor weighted default rate of such performance guarantees is below 0.5 percent.[7] This is also clear intuitively as potential sellers will try to avoid that guarantees will be drawn by buyers, because such an event would cause a massive loss of reputation which will not be only relevant in the specific contract but for all potential business relations in the future. Furthermore, for banks using internal models a standard maturity of 2,5 years will have to be applied to these contracts which also does not reflect the reality where many guarantees have a much shorter maturity (Art. 162 CRR in conjunction of the prohibition of advanced internal models for large exposures with large corporates). According to the ICC most trade finance products have average tenors of below 130 days.

As a result of the Commission's proposal, the costs for the guarantees might go up by 150 percent as banks have to provide 2,5 times more equity for these products. This appears unjustified and will be at the

6 A typical example where guarantees play a key role for industrial companies are long-term projects where the buyer is obliged to make an initial payment in advance of the project start and the seller is expected to finalise the project within a certain period of time. Bank guarantees are used for insuring the initial or subsequent payments against default and for ensuring that the project is finalised in due time and with the performance that has been agreed.

7 See the exposure weighted figures in the report, https://iccwbo.org/publication/icc-trade-register-report/

disadvantage of companies in Europe. We therefore encourage the legislator to maintain to the existing credit conversion factors which has proven to be robust and effective.

5. Attention needs to be paid to potential and unintended negative consequences of amendments to central definitions of the CRR – most notably the definition of “financial holding company” (Art. 4 para. 1 point (20)) and “ancillary services undertakings” (Art. 4 para. 1 point (26)(b)(ii)). We understand that these amendments to the definitions aim at addressing specific cases of companies whose core business is to offer financial services in a broader sense, but existing definitions may not be clear enough to cover these de facto financial service providers properly. It is furthermore our understanding and assumption that there is no political intention to classify non-financial groups as financial institutions or financial holding companies the core business of which is clearly not the provision of financial services (neither in a narrow nor in a broad sense). These companies currently do not run the risk to be classified as financial holding companies, even if they have a fully regulated financial sector subsidiary in their group supporting the core business. However, the definition changes appear to entail some deficiencies that need to be addressed in an adequate manner in order to avoid any misinterpretations. Against this background some additional explanations in the recitals and some minor amendments to the definitions proposed are necessary which we explain in detail in the Annex of this position paper.

Annex: Analysis of the proposed amendments to certain definitions from the perspective of non-financial companies

General Remarks

One of the elements of the CRR 3 proposal are enhancements to central definitions of Article 4 of the CRR. These changes may have significant implications as the definitions ultimately define which companies/groups of companies will be regulated and supervised directly by financial supervisory authorities.

The explanatory part of the proposal highlights that the definition changes are included in order “to ensure that financial groups that are headed by fintech companies or include, in addition to institutions, other entities that engage directly or indirectly in financial activities are subject to consolidated supervision” (p. 10).

It is our understanding that the amendments to the definitions aim at addressing specific cases of companies whose core business is to offer financial services in a broader sense, but existing definitions may not be clear enough to cover these de facto financial service providers properly. We agree with this objective and support it.

However, it has to be avoided in any case that non-financial-companies be unintentionally classified as financial institutions or financial holding companies due to the definition changes. This could mean that from a purely legal perspective they form a financial holding group, simply because they have a financial sector subsidiary in the group, although the core business of the broader group is clearly not the provision of financial services, but an industrial business.

Though our understanding is that there is no political intention to bring those groups into scope of the regulation, the definitions appear to entail some deficiencies that need to be addressed in an adequate manner in order to avoid any misinterpretations.

- Vague Terms may be interpreted in a too wide manner by supervisory authorities. Accordingly, at least the recitals should define limits to the definitions and give additional guidance regarding the political objectives behind the definition.

- Modification of the syntax of existing definitions may also give raise to interpretation issues. Here, it should be made clear that these are only syntax changes but not material changes.

- Additional elements of definitions that overshoot if they are interpreted too close to the wording of the text. These changes should be corrected or even reversed in order to avoid such overshooting.

Specifically, the following definitions should be addressed:

Financial Holding Company

The proposed definition of financial holding company in Art. 4 para. 1 point (20) reads as follows:

(20) financial holding company' means an undertaking fulfilling all of the following conditions:

(a) the undertaking is a financial institution;

(b) the undertaking is not a mixed financial holding company;

(c) at least one subsidiary of that undertaking is an institution;

(d) more than 50 % of any of the following indicators are associated, on a steady basis, with subsidiaries that are institutions or financial institutions, and with activities performed by the undertaking itself that are not related to the acquisition or owning of holdings in subsidiaries when those activities are of the same nature as the ones performed by institutions or financial institutions:

(i) the undertaking's equity based on its consolidated situation;

(ii) the undertaking's assets based on its consolidated situation;

(iii) the undertaking's revenues based on its consolidated situation;

(iv) the undertaking's personnel based on its consolidated situation;

(v) other indicator considered relevant by the competent authority

Currently, non-financial groups the core business of which is clearly not the provision of financial services (neither in a narrow nor in a broad sense) do not run the risk to be classified as financial holding companies. This is fully justified and should hold true in future.

We assume that the amendments to Art. 4 para. 1 point (20) also follow that basic understanding.

However, this should and could be made clearer:

- First of all, given the wide room for interpretation inherent to the definition we strongly suggest to specify in a recital that the changes to the definition are not aiming at non-financial groups the core business of which is clearly not the provision of financial services (neither in a narrow nor in a broad sense) are not in the scope of CRR 3 and do not run the risk to be classified as financial holding companies.

- The term “when those activities are of the same nature as the ones performed by institutions or financial institutions” is again too vague and could raise misinterpretation issues. If this should refer to the activities listed in the Annexes to Mifid and the CRD IV, reference should explicitly be made in the wording to the relevant activities listed in the Annexes to the MiFiD and the CRD IV as stated in the definition of financial institutions. If this aims to cover ancillary services such as IT-services (as it was the case in the Wirecard organization), we ask to delete it as this was a very specific group constellation deviating from the group structures in place in big non-financial industrial groups and as it is easy to circumvent by restructurings. And last but not least, ancillary services undertakings are already covered by the extension of the definition of financial institutions, so that this amendment creates redundancies that open room for misinterpretations and create legal uncertainties.

- We assume that the modification of the syntax of the definition with regard to “any of” the activities mentioned under (i) to (v) is not undertaken with an intention to change supervisory practices. Otherwise, this intention should be flagged in order to allow for a proper analysis of the consequences.

Ancillary Services Undertaking

The definition of an “ancillary services undertaking” is important because these undertakings will in future be financial institutions according to Art. 4 para. 1 point (26)(b)(ii). Accordingly, their activities will be considered when determining whether or not a firm will be classified as “financial holding company” according to Art. 4 para. 1 point (20).

The proposed definition of ancillary service undertaking reads as follows:

(18) ‘ancillary services undertaking’ means an undertaking the principal activity of which, whether provided to undertakings inside the group or to clients outside the group, the competent authority considers to be any of the following:

> *(a) a direct extension of banking;*
>
> *(b) operational leasing, factoring, the management of unit trusts, the ownership or management of property, the provision of data processing services or any other activity that is ancillary to banking;*
>
> *(c) any other activity considered similar by EBA to those mentioned in points (a) and (b)*

This definition raises a number of concerns:

- Point (a): the term „direct extension of banking" is too vague and currently neither defined nor used in the CRR.

- Point (b) is a clear extension of the current understanding of ancillary services. The objective behind this extension is however not explained by the EU Commission so that the impact cannot be evaluated. Ideally the extension should be reversed. At least, it must definitely be clarified that the sentence "that is ancillary to banking" also relates to operative leasing, factoring and the management of unit trusts. Otherwise, for example any entity that performs operative leasing would have to be classified as an ancillary service undertaking.

- Point (c) creates an enormous room for discretion for EBA which even reinforces the problems with the other elements of the definition. It is therefore even more important to clarify the intention of the definition as well as providing limits to overly wide interpretations

Against the background of the concerns above, the definition of ancillary services undertaking should better not be widened at all.

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