Deutsches Aktieninstitut

Basel IV in the EU

Taking the opportunity to adapt a well-balanced proposal to European corporate realities

Position Paper of Deutsches Aktieninstitut on the proposed amendments of members of the ECON to the EU Commission's Banking Package implementing the remaining parts of the Basel III framework,
11 November 2022

Reflecting European Realities

I am writing you to draw your attention to the view of non-financial companies organised in Deutsches Aktieninstitut regarding the implementation of the remaining parts of the Basel III framework into EU legislation (EU Banking Package).[1]

We 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 the allocation of capital and thus growth of the entire economy. However, we also believe the transposition of the remaining parts of the Basel III framework must recognize that European exporters and importers need reliable and cost-efficient banking services that support their role in the global economy. This is particularly true for the ability of banks 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. In addition to that, it needs to be reflected that the vast majority of European companies, even large ones, are unrated.

Against this background we would like to comment on the current state of discussions in the European Parliament reflected in the draft report and the proposed amendments.

More specifically Deutsches Aktieninstitut asks for taking into consideration the following aspects:

1. We strongly support that the European Commission's proposal as well as the ECON draft report maintain 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 was once introduced to recognize the specific importance of derivatives for the risk management of non-financial companies and the specific low-risk characteristics of the derivative exposures resulting from that fact. Consequently, there has been a broad political understanding not to make the use of OTC

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.

derivatives for hedging against currency, interest rate and commodity price risks too expensive or restrict their supply. In fact, the disapplication of the exemption would nullify most cost savings that EMIR is providing for the real economy. All of the arguments for that exemption still hold true.[2]

We are therefore strongly concerned that a few of the amendments (in particular no. 1128, 1129 and 1130) call into question this well justified and necessary provision. We urge the Parliament not to follow these proposals.

2. We also support that the EU-Commission's 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 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.[3] However, this measure might be phased out after 2029, as it will be up to EBA to determine the final alpha-factor according to the EU Commission's proposal. From our perspective the EU should follow the US example and set the factor at 1, at least 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.

   Against this background, amendments no. 1275 to 1279 appear to reflect our concerns and are supported by us. In contrast, amendments no. 1271 to 1274 propose to delete the transitional period which would result in an alpha factor of 1.4 and impose additional burdens to both banks and their customers. If a permanent lower alpha factor of 1.0 cannot be agreed upon the original proposal of the Commission should be preserved at least. A transition period would allow for a proper analysis of the impact as well as international developments before a permanent solution will be implemented.

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2 See for example Position Paper of Deutsches Aktieninstitut on the EBA Consultation Paper on possible "Guidelines on the treatment of CVA risk under the supervisory review and evaluation process (SREP)" (EBA/CP/2015/21), 12 February 2016.

3 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.

3. Similar to our considerations on the alpha factor, we basically support any proposal that recognises that capital requirements need to be adjusted to the reality of the high number of unrated corporates among European companies. We also do not believe that it is realistic that a rating will be available in a cost-efficient and reliable manner anytime soon for the vast majority of unrated European companies. Thus, we are concerned that the transition period as proposed by the EU Commission (Art. 465 (3)) CRR, though helpful, will result in a cliff effect on the financing costs for unrated corporates at a later point in time.

This concern appears to be shared among a number of MEPs with amendments addressing this issue. In particular, we support amendments that suggest to make the treatment of unrated companies permanent (amendment no. 1230 and 1233 to 1241) and/or aim at a permanent solution to be defined only on the basis of a proper analysis.

In contrast, we are concerned about amendments that either delete the transition period suggested by the EU Commission (e.g. no. 1224 to 1228) or propose to apply the preferential risk weights only to credit exposures to smaller companies during the transition period (amendment no. 288 in the draft report and amendment no. 1229). Like our comments to the alpha factor above, at least the original proposal of the EU Commission needs to be kept in substance in order to gain time for a proper analysis.

4. The Commission's proposal has among other things increased the so-called credit conversion factors for widely used instruments of trade finance such as technical guarantees (e.g. advance payment bonds, performance bonds, bid bonds, and warranty bonds) from 20 percent to 50 percent. These guarantees are typically 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.[4]

As a consequence of the proposal of the EU Commission the costs for such guarantees might rise by up to 150 percent as banks have to provide 2,5 times more equity for these products which would make the export business of European companies significantly more expensive and would disadvantage European companies in international competition.

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4 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.

A number of members of ECON appear to share this concern and propose to maintain the existing credit conversion factors by reclassifying the respective instruments in the Annex to the regulation (see amendments no. 1541 ff.). Accordingly, the credit conversion factor for the relevant instruments would stay at 20 percent which we fully support.

5. The EU Commission proposed to amend a number of central definitions of the CRR, in particular the definition of ancillary services undertakings (Art. 4 para. 1 no. 18) and linked to that the definition of financial holding companies (Art. 4 para. 1 no. 20).

These proposed changes 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 has been 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).

However, this political intention is not fully reflected in the wording of the Commission's proposal on ancillary services undertakings which is very far reaching, captures too many activities and is too vague granting room for interpretation by supervisory authorities. As a consequence, non-financial groups face legal uncertainty and may unintentionally be captured by the CRR definition which ultimately could mean that they would have to comply with provisions of the banking regulation on group level.

This risk of overshooting the scope has obviously been recognized by members of the European Parliament as there are a number of amendments trying to make the scope more precise. We share the concerns reflected in these amendments.

In particular, we support amendment no. 370 which clarifies that ancillary services need to be "ancillary to the principal activity of one or more *institutions*" (which clearly links the definition to activities of a legally defined financial entity instead of linking it to the vague term "banking" as in the EU Commission's proposal). This is also reflected in amendment no. 376. We also support amendments which reduce the list of activities to be considered as ancillary irrespective of the individual situation of the company in question (in particular operational leasing, no. 372 to 377) and which limit the discretion of supervisory authorities to add activities not reflected in the list (no. 379 to 381).

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