Deutsches Aktieninstitut

CRD 5/CRR 2 Should Take Care of Non-Financial-Companies Risk Management Needs

Empowerment of EBA Could be Used to Countervail the CVA Exemption of Art. 382(4)a) CRR

Position Paper of Deutsche Aktieninstitut on the Proposal to Amend Directive 2013/36/EU (the Capital Requirements Directive or CRD) and a proposal Regulation (EU) 575/2013 (the Capital Requirements Regulation or CRR), 15 January 2018

Summary and General Remarks

On 23 November 2016 the EU Commission issued a proposal to amend Directive 2013/36/EU (the Capital Requirements Directive or CRD) and a proposal Regulation (EU) 575/2013 (the Capital Requirements Regulation or CRR) in order “to complete the reform agenda by tackling remaining weaknesses and implementing some outstanding elements of the reform that are essential to ensure the institutions' resilience but have only recently been finalised by global standard setters (i.e. the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB)) (hereafter referred to as the CRD 5/CRR 2-proposal).

In the meantime, both the Council of the European Union and the European Parliament have formed preliminary views on the file, with European Parliament having issued the draft report in late November 2017.

Deutsches Aktiensinstitut therefore takes the opportunity to comment on both developments. In general, this **position paper contains the comments of German non-financial companies on the CRD 5/CRR 2 proposal.** Our view is based on discussions in the corporate finance/corporate treasury working group of Deutsches Aktieninstitut[1] which is the central forum of opinion building for the treasury departments of the largest German non-financial companies.

Non-financial companies have generally been supportive to the strengthening of bank and capital market regulation in the aftermath of the crisis because systemic stability in general and safe and sound banks are key for the allocation of capital and thus growth of the entire economy. In this context, it is our understanding that the EU Commission’s proposal mainly aims at implementing outstanding topics from the **Basel III package** which **we also basically support.**

However, we also **believe that the regulation of banks – if too strict – may interfere with the banks’ role as intermediaries and risk takers for the economy**. Indeed, we have always pointed to the fact that there is to a certain degree a trade-off between the risk limiting effects of regulation on the one hand and negative side effects on the role of banks for the economy and for users of financial services on the other.

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[1] Deutsches Aktieninstitut (EU transparency register: 38064081304-25) represents the entire German economy interested in the capital markets. The about 200 members of Deutsches Aktieninstitut are listed companies, banks, stock exchanges, investors and other important market participants. This position paper is based on discussions in the corporate finance/corporate treasury working group which is the central forum of opinion building for the treasury departments of the biggest German non-financial companies in the German market.

This is **particularly true with respect to the use of derivatives by non-financial companies to hedge risks resulting from their operative businesses**. This use of derivatives for hedging purposes stabilizes income flows and – ultimately – improves the long-term creditworthiness of non-financial companies.

It has therefore been widely **acknowledged by legislators that regulation should not constrain the use of derivatives by non-financial companies, neither directly nor by creating prohibitive cost environments**. Accordingly, the regulator has rightly introduced some elements in the EU Derivative Regulation EMIR, the MiFIR/MiFID 2 package and the existing CRR/CRD IV that acknowledge the specifics of the use of derivatives by non-financial companies in order to avoid negative side effects on business operations.

With regard to the CRR/CRD IV the most notable provision in that respect is the exemption from the own funds requirement for credit valuation risks (CVA risks) for exposures from derivatives with non-financial counterparties according to Art. 382(4)a) CRR). We therefore applaud, that neither the EU Commission's proposal nor any amendment made by the European Parliament or the Council of the European Union suggests to remove this important exemption for the non-financial companies.

However, it is not yet ensured that the **strong political will**, which **has been confirmed in the latest proposal on the EMIR review and has been reinforced in the reaction of the European Parliament to the Basel III implementation report of the Basel Committee**[2] will also persist materially due to other changes to the CRR 2/CRD 5 package.

In particular, we are concerned that **the proposal will indirectly interfere with the exemption of Art. 382(4) and thus may have significant negative impact** on the prices, the availability and the liquidity of hedging instruments:

- The proposed **amendments to Art. 104ff. CRD may** change the nature of the supervisory review and evaluation process (SREP) as they may, in effect, increase EBA's as well as national competent authorities power to **counteract the CVA risk exemption of Art. 382(4)a)** through the "back door" of supervisory action. In the past, Deutsches Aktieninstitut has therefore strongly opposed the EBA's attempts to issue a regulatory Guideline on the SREP which has had the potential to de facto remove that exemption. The current proposal grants overaching powers to EBA would rather strengthen EBA's competences in that respect.

[2] Reaction to the opinion of the Basel Committee on CRD 4, 5 December 2014, http://www.europarl.europa.eu/news/lv/news-room/20141205IPR82904/REACTION-TO-THE-OPINION-OF-THE-BASEL-COMMITTEE-ON-CRD-4

We thus ask the legislator to clarify **that the provision of Art 104ff. CRD (and in particular Art. 104a (2) sub 2) cannot be used to counteract explicit exemptions granted in the CRR, particularly in Art. 382(4)a) on a principal basis.**

Unfortunately, neither the Draft Report of the European Parliament nor the existing compromise proposals of the Council appear to recognize the potential negative impact of a changed nature of EBA's competences in that respect. Both co-legislators rather tend to even increase EBA's powers in that respect because they could be read as if additional own funds requirements for risks excluded under Art. 382(4) CRR should be the rule rather then the exemption.

- In addition to the general critique we also do not see any need for EBA to issue a RTS on the SREP as it is provided by Art. 104a (6) CRD of the EU Commission's proposal. According to the regulatory concept of the SREP competent authorities should evaluate on a bank specific basis whether in certain exceptional circumstances more own funds should be required than would result from the formal own funds requirements. The regulatory idea is not, that risk evaluation is harmonized and even less that national competent authorities have to apply additional own funds requirements if harmonized metrics indicate action. From our point of view the discretionary nature of the SREP does not require European Guidelines and even less Regulatory Technical Standards.

  Against this background we support the EP rappoteur's suggestion as well as the latest public Council's compromise text which both remove the competence of EBA to issue an RTS regarding the risk evaluation under Art. 104 CRD.

- Furthermore, the treatment of derivatives within the implementation of the **Net Stable Funding Ratio (NSFR)** should be analysed in depth. Our general request is that potential negative impacts on the prices, the availability and the liquidity of hedging instruments are carefully evaluated and understood before the NSFR is implemented in Europe. In particular, **we still do not fully understand the rationale for the RSF-factor for gross derivative liabilities according to Art. 428u(2) and Art. 428x(2), especially the 10% surcharge on uncollateralized derivatives**. At least without further evidence and explanations provided a bank's gross derivative liabilities appear to be an inappropriate indicator of its market contingent funding requirements as these cannot be evaluated without simultaneously regarding derivative assets. At the very least, the co-legislators should use the flexibility just granted by the Basel Committee to reduce the factor to 5 percent.

The remainder of this position paper lays down our arguments in detail.

Amendments to Art. 104ff.

Articles 104ff. implement the so-called pillar 2 requirements of the Basel Accord into European law in defining the conditions and the scope of the supervisory review and evaluation process (SREP). According to the regulatory concept of the SREP competent authorities should evaluate on a bank specific basis whether in certain extraordinary bank-specific circumstances more own funds should be required than would result from the formal own funds requirements.

Although the EU-Commission clarifies this micro-prudential concept of the SREP, **the current proposal will potentially make worse the problem that the SREP process can be used by the EBA and/or the NCAs to countervail exemptions from the own funds requirements provided for good reasons by the legislator**.

This is **particularly true for the exemption of Art. 382(4)a) CRR from CVA capital requirements for derivatives with non-financial counterparties (NFCs)** which was granted to ensure consistency of the CRR/CRD IV package with EMIR and other regulations in order not to hinder NFCs risk management practices.

Limit the scope of the Supervisory Review Process

The proposal of Art. 104a (2) sub 2 reads

> "For the purposes of the first subparagraph, the capital considered adequate shall cover all material risks or elements of such risks that are not subject to a specific own funds requirement. This <u>may include risks or elements of risks that are explicitly excluded from the own funds requirements</u> set out in Parts Three, Four, Five and Seven of Regulation (EU) No 575/2013."

This amendment, thus, basically constitutes that EBA and NCAs may "overrule" any binding own funds requirements on a discretionary basis.

We have good reason to believe that the CVA exemption granted by Art. 382(4)a) CRR may be one of the most important issues that may come under pressure through that action: Since the CRD IV/CRR has entered into force there has been a long discussion on exactly that point after EBA has issued a draft Guideline on the treatment of CVA risks under the SREP process. This Guideline which would have removed substantial parts of the positive effects of the exemption of Art. 382(4)a) for NFC exposures has not been finalised yet because of strong resistance and legal uncertainty on the scope of the mandate. We are therefore deeply concerned that the amendments will restart that debate and may finally lead to the de facto removal of the exemption of Art. 382(4)a) on a principle basis.

Unfortunately, neither the Draft Report of the European Parliament nor the progress report of the Council appear recognize the potential negative impact of a changed nature of EBA's competences in that respect. The EP draft report could be read as even enlarging the EBA's powers because it clearly states "risks or elements of risks shall not be regarded as being covered by Regulation (EU) No 2013/575 if they are explicitly excluded from the own funds requirements set out in Parts Three, Four, Five and Seven of that regulation or are not covered by that regulation" (Amendment no. 28). The current drafting of the Council appears to take a similar direction. As a consequence, **additional own funds requirements for risks excluded under Art. 382(4)a) CRR could rather be the rule then the exemption.** In contrast even the EU Commission proposal – albeit also wider in scope than the existing CRD - uses the key word "may" for defining which elements of risks own funds requirements should be evaluated by supervisory authorities.

From the perspective of non-financial companies the political discussion should better seek to protect the existing exemption from being countervailed by the SREP process. At a minimum it should be ensured that supervisory action can only be taken under exceptional circumstances instead of a standard procedure. To limit the scope for supervisory action Art. 104a (2) should thus be amended as follows.

Text proposed by the Commission	*Amendment*
For the purposes of the first subparagraph, the capital considered adequate shall cover all material risks or elements of such risks that are not subject to a specific own funds requirement. This may include risks or elements of risks that are explicitly excluded from the own funds requirements set out in Parts Three, Four, Five and Seven of Regulation (EU) No 575/2013	For the purposes of the first subparagraph, the capital considered adequate shall cover all material risks or elements of such risks that are not subject to a specific own funds requirement. ***Only in exceptional circumstances, where the risk concentration of an individual institute demands such a measure***, this may include risks or elements of risks that are explicitly excluded from the own funds requirements set out in Parts Three, Four, Five and Seven of Regulation (EU) No 575/2013

Alternatively and if the legislators whish to make even clearer that the exemption should not be countervailed by discretionary supervisory action this could explicitly be reflected in the wording: "This may include risks or elements of risks that are explicitly excluded from the own funds requirements set out in Parts Three, Four, Five and Seven of Regulation (EU) No 575/2013 – ***other than the exemption granted in Art. 382(4)a) CRR***".

A clarification of that kind is important to protect the economic and political rationale not to establish a CVA capital requirement for derivatives of certain NFCs, without undermining the SREP in circumstances where it is really needed. [3]

- **No systemic risk:** This was decided after rightly recognizing the fact that the derivatives portfolios of NFCs typically have a low risk profile and do not create systemic risks because they are simply mirroring "real economy" business. As derivatives used by NFCs are in general linked to commercial or treasury financing activities, such derivatives do not pose additional risks to the economy as a whole. A negative market value of the derivative is widely offset by a positive performance of the underlying exposure from operative business (and vice versa). The total risk arising from that constellation is almost zero, making these exposures a form of "right way risk". Opposite to that, an unhedged NFC poses more counterparty risk to banks, bondholders and stockholders than a hedged one. This has also been acknowledged in the IFRS accounting standard IAS 39 for hedge accounting.

- **Ensuring consistency with EMIR:** The CVA exemption of Art. 382(4)a) CRR is also the logic equivalent to the clearing exemption under EMIR. There was the clear political will not to undermine the EMIR exemption (and the cost savings related to it) through higher capital charges on exactly the same derivative contracts. As mentioned above this political will has just been reinforced by the EU-Commission's proposal on the review of EMIR which still contain the clearing exemption as a pivotal element. Consequently, the CRD V/CRR 2 proposal also remains the exemption.

- **Avoiding dwindling risk management:** The consequence of granting EBA the power to countervail that exemption through discretionary supervisory action could, hence, be a devaluation of the EMIR exemption so that less financial market risk would be hedged and instead ultimately be borne by NFCs, making them "unsafer" counterparties in turn – a consequence that cannot be in the interest of the European Union.

- **Avoiding negative impact on liquidity and banks' risk exposure:** Furthermore, NFCs might decide to collateralize their derivative positions in order to avoid additional CVA charges. This, however, would not be possible without additional funding sources because contrary to banks NFCs usually do not have financial assets on their balance sheets that

[3] See for detailed explanation e.g. Deutsches Aktieninstitut, Briefing Note on EBA Report on CVA, 4 May 2015

could be used. Such additional funding will have to be raised in the banking sector. An increased (forced) collateralization of derivatives will create a liquidity drain even be going beyond the expected average of market value moves, as a prudent corporate treasurer would put aside “oversize” credit lines for this purpose which can even accommodate extreme market conditions as seen in the financial crises. As a consequence, transforming uncollateralised derivatives with NFCs into collateralised ones would not improve overall counterparty risks for the banking sector. The counterparty risk will simply take another form – instead of counterparty risk from a derivative exposure banks will face a counterparty risk from financing facilities they are providing for NFCs.

From the perspective of the non-financial sector it is therefore of utmost importance that not only the exemption of Art. 382(4)a) remains (as it is proposed) but it is also avoided that the exemption can be countervailed de facto by supervisory authorities.

No RTS necessary

For the same reason we are **concerned about the proposal of Art. 104a(6) CRD 5 that allows the EBA to issue a RTS** specifying how the risks under the SREP should be measured. We fear that this would result in a fully harmonised treatment of CVA risks across Europe which could change the very nature of the SREP. The regulatory idea of the SREP is not, that risk evaluation is harmonized and even less that national competent authorities have to apply additional own funds requirements if harmonized metrics indicate action. From our point of view the discretionary nature of the SREP does not require European guidelines and even less Regulatory Standards. In contrast, from our perspective the regulatory concept of the SREP is that competent authorities should evaluate on a bank specific basis whether in certain extraordinary circumstances more own funds should be required than would result from the formal own funds requirements. For this idea to be employed, supervisory authorities need flexibility and discretion which is clearly limited under a Guideline and even more under a RTS.

We therefore fully support amendment no. 33 of the ECON’s draft report as well as the latest public Council’s compromise to delete the respective provision.

Treatment of Derivatives according to the Net Stable Funding Ratio (NSFR, Art. 428aff. CRR)

Our general request with regard to the European implementation of the Net Stable Funding Ratio (NSFR) is that potential negative impacts on the prices and the availability of hedging instruments are carefully evaluated and understood before the NSFR is implemented in Europe.

In general, we would therefore like to encourage the co-legislators to analyse in depth the treatment of derivatives according to the NSFR.

In a previous consultation on the NSFR we have hence raised our concern in particular on the RSF factors for gross derivative liabilities. Though we recognize that the EU-Commission intends to deviate from the original proposal of the Basel Committee in some respects, we **still do not understand the rationale for the 10% RSF-factor for uncollateralized gross derivative liabilities provided in Art. 428u in general, nor do we understand the choice of 20% as a RSF factor for collateralized gross derivative positions**. At least without further evidence and explanations provided a bank's gross derivative liabilities appear to be an inappropriate indicator of its market contingent funding requirements as these cannot be evaluated without simultaneously regarding derivative assets.

In addition to that, there are some specifics with derivative positions banks have vis-à-vis non-financial counterparties that use derivatives for hedging purposes that make the justification of the RSF-factor even more disputable in case of derivatives with non-financial companies. This particularly applies, if those hedges are regularly conducted on an uncollateralized basis. It is argued that the RSF factor on gross derivative liabilities is supposed to counter a hypothetical risk from a potential future requirement for the bank to post collateral. We would not expect that non-financial companies would be keen to post collateral in future as this would result in significant funding requirements (see above). Quite the opposite is true so that the hypothetical posting of collateral cannot be taken as a reason for additional funding requirements.

In sum, we do not fully understand the rationale of the RSF factors for gross derivative liabilities as well as its level and we encourage the legislator to evaluate alternatives or at least to follow the more recent communication of the Basel Committee that allows to limit the RSF-factor to a 5 %-level. Otherwise, we are concerned that hedging of the business operations of the non-financial sector may become more costly or the availability of hedging instruments may shrink if banks are not able to refund the relevant positions in the market. If such an effect materialised we would regard it as an inconsistency in the EU financial market regulation that has rightly recognized that the use of derivatives of non-financial companies is generally beneficial for the economy.

Other aspects

We have commented on detail on the points mentioned above because these issues have in common that a direct impact on the prices and the availability of derivatives of non-financial companies appears likely.

This, however, does not mean that all other issues of the CRR 2/CRD 5 package will not be problematic in terms of impact on markets and users of financial services. Indeed, a number of reports summarize examples of potential negative impacts on the real economy (e.g. the treatment of equity inventories under the NSFR that could hinder the investment in equities by institutional investors), which from our point of view deserve closer analysis. Although non-financial companies are unfortunately not in the position to comment on details of these regulatory aspects, we encourage co-legislators to analyse these points thoroughly.

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