POSITION PAPER

4 November 2011

CRD IV

COMMISSION PROPOSALS FOR REVISION OF THE CAPITAL REQUIREMENTS DIRECTIVE

Introduction

BUSINESSEUROPE is in favour of smart regulation for financial services in response to the regulatory failures that led to the financial crisis and to address the risk of similar events occurring in the future. BUSINESSEUROPE therefore supports reinforcing prudential rules as financial market stability is fundamental for the economy and European companies. However, the new rules will have a significant impact on the financing of the European economy and in particular on the financing of smaller and medium-sized European companies (SMEs) as well as start-up and growth companies. This will be even more serious considering the cumulative effects of the different prudential rules combined with other financial reform measures such as Solvency II, UCITS 4, rules on Deposit Guarantee Schemes, the European Market Infrastructure Regulation (EMIR), the review of the Markets in Financial Instruments Directive (MiFID) and forthcoming proposals for an EU Crisis Management Framework. The recent agreement on bank recapitalisation and revaluation of sovereign debt to market value will also significantly affect financing conditions. At a time when the economic recovery can only be sustained through an increase in corporate investment, the implementation of reform measures could create an overall shortage of companies' main sources of financing. This should be avoided.

Facilitate SME financing

To counter adverse consequences on SME lending, BUSINESSEUROPE suggests the introduction of structures within the CRD IV framework to facilitate financing of SME. This could be done for example by introducing a so-called SMEs Supporting Factor of 76.19% to be applied in the Risk Weighted Assets (RWA) calculation for loans to SMEs in order to balance out the quantity increase in minimum capital requirements. The multiplier, acting on the total RWA amount, maintains the final capital requirement to the current one of 8% even if capital of higher quality is anyway required. This will induce banks to focus more on traditional lending and guaranteed lines of credit to SMEs which is vital considering the main role played by European banks in credit transformation and the fact that European SMEs depend highly on bank lending (the European banks' share of credit intermediation is 3 times higher than in the US and small businesses lend 2 times more from banks than large corporations).

Liquidity

Regarding liquidity, we welcome the progressive implementation of the liquidity ratios with a non-binding observation period even though in practice - as we have seen with the capital requirements - financial institutions may feel compelled to meet standards earlier thereby advancing any negative effects on the availability of financing. At the

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end of the observation period for the liquidity and leverage rules – before they are implemented on a binding basis – regulators should be required to undertake a thorough and open minded review of their impact, effectiveness and calibration. This should include considering the potential effects of the rules on a range of businesses.

For instance, liquidity ratios may negatively affect certain specialized financing schemes related to equipment or commercial real estate leasing or trade finance or FX hedging, which are also useful to support SMEs. Moreover, the proposed liquidity rules significantly favor deposits over certificates of deposits (CDs), ignoring the continuous subscription of CDs by market players which permits the making of similar stability assumptions for both deposits and CDs. Similar risks should be given similar treatment, consequently, a renewed statistical assumption for CDs should be applied to reflect this unjust difference of treatment.

Sovereign debt

The proposed liquidity rules favour government bonds over high quality private debt securities as liquidity buffers. In our view, there is no reason for this given recent developments in the euro-area. Currently, with the spreads between sovereign issuers higher than the risk free rates, the rules are increasingly difficult to apply. They would also lead to a clear reduction of investment in corporate bonds and should therefore be remedied as it would create a risky concentration of sovereign debt exposure in financial institutions. In this context, we favour a widening of the definition of liquid assets considered eligible by the European Central Bank for these instruments.

Liquidity management

BUSINESSEUROPE believes that the new rules should also reflect fundamental principles such as the effective functioning of the EU passport, preventing the ring-fencing of liquidity pools and improve price disclosure. This becomes increasingly important given the increased tendency that liquidity needs to be reported, monitored and managed on entity level. In case this is not sufficiently taken into account, the functioning of the European internal market and especially the European banking sector can be hampered.

Asset-backed security loans

The CRD IV proposals also stipulate that asset-backed security (ABS) loans should not count towards the liquidity coverage ratio – unlike sovereign bonds and covered bonds. In addition, agreed liquidity lines should be included in full for calculation of liquidity outflows within the next 30 days in the framework of banks' securitization activities. Considering that often credits used by businesses are mainly re-financed via ABS, non-inclusion of ABS holdings makes it less attractive for banks to invest in these products. ABS loans that are accepted by the European Central Bank for repo business should therefore also be recognized in the calculation of the liquidity coverage ratio. The new rules should step away from a complete matching of liquidity lines on securitization of trade and leasing loans. ABS loans are also an important instrument in financing the real estate industry. In addition to the impact mentioned above, the leverage ratio should reduce the attractiveness of lower risk engagements like mortgage debt.

Trade finance

Export finance will also be affected by new liquidity rules as it will be by the introduction of a maximum debt ratio (leverage ratio) and a reduction of US dollar liquidity by US banks. Export finance often involves backing by an export credit agency (ECA). Considering that no important credit losses have been reported by banks that have financed ECA-guaranteed transactions, these loans should not be included in the calculation of the leverage ratio with a 100% uniform credit conversion factor. In addition, these loans should constitute eligible collateral for central banks as this would facilitate the obtaining of export finance by companies.

Off-balance sheet exposure

Legislators should also reconsider some specific elements of the calibration of the capital regime for off-balance sheet exposures more generally considering that evidence suggests that the credit conversion factors, and other elements of the calculations that are applied for the leverage ratio in respect of certain types of business such as for example trade finance, may be too high.

Derivatives

The CRD IV proposals also impact on the trading of 'over-the-counter' derivatives (OTC derivatives). It regards proposals with respect to minimum own funds requirements for credit valuation adjustment risk (CVA) which could force banks to hold about 4-5 times more capital than under current rules. BUSINESSEUROPE is concerned that such punitive requirements will significantly increase costs when they are passed on to customers and harm retaining active OTC derivatives market for non-financial companies to hedge market risks.

High cost and lack of capacity will discourage end users from entering into OTC derivative transactions. This would lead to corporations stop hedging risks, increasing not only the risk for the single corporation concerned but also for the economy as a whole. The exemption for non-financial companies contained in the EMIR proposal reflects the importance of this kind of transactions. The European Parliament confirmed this in their first reading assessment of the proposal and it is crucial that new capital rules do not undercut this.

We therefore suggest adopting an exemption from the obligation to match CVA risks of derivatives that are used by industrial undertakings for hedging purposes (for example related to price changes of commodities, currencies or interest rates) against capital or at least a recalibration of the calculations used in order that the capital charge is proportionate to the risks posed. In addition, there should be a reduction of the capital requirements through adjustments in calculation of the CVA so that the discrimination vis-à-vis CCP-cleared derivatives is removed. We are concerned that the proposed treatment for members of CCPs, which consists of charges for exposure to default funds in addition to the charges against the end users will either disincentivise banks from being clearing members of CCPs or result in banks significantly increasing the cost of clearing services. This would have the effect of reducing choice for corporates

wishing to hedge their financial risks. Having said this, enforcement of CRD IV should be closely linked to an obligation of transparent, user-friendly and robust clearing houses.

Technical standards

The European Banking Authority will get a much expanded role under the new rules. It will be required to develop technical standards which will determine how some key elements of the rules will be applied in practice. These technical standards will be binding on national authorities and enforce consistent application of EU laws. Delegated acts should be used only where a convincing case for their use can be made, and where the European Banking Authority and the European Securities and Markets Authority have sufficient resources to complete the development of the technical standards and the related consultation process in a timely manner.

Level playing field

Any unilateral approach in this area needs to be avoided. The G20 called for greater international co-operation and consistency and it is thus important that third countries also implement the Basel bank reforms in accordance with their commitments at the G20 meetings.

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