

Why Bank Competitiveness Matters Beyond the Financial Sector

A non-financial companies' perspective on the
upcoming report on bank competitiveness

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The EU Commission is currently preparing a report on the competitiveness of the European banking sector.

Deutsches Aktieninstitut welcomes this initiative as an important opportunity to take stock of the current regulatory framework and revise certain provisions in a targeted manner in order to ensure that European banks remain capable of providing the financial services at sufficient scale and affordable prices that the real economy depends upon, thus ensuring the non-financial companies remain to have broad choices among banks offering these services.¹

European non-financial companies need to have choices among strong bank partners

Non-financial companies have been generally supportive of measures to strengthen bank regulation in the aftermath of the financial crisis, recognising that systemic stability and sound banks are essential for the allocation of capital and the growth of the economy as a whole. However, we also firmly believe that bank regulation — if too strict or inappropriately calibrated — may interfere with the role of banks as intermediaries and risk takers for the economy. Non-financial companies need a strong banking sector that ensures the availability of relevant financial services at competitive prices. While the stability of EU banks has been strengthened due to the regulatory framework, we also observe that the overall level of regulatory requirements and supervisory interpretation of the existing framework increasingly interferes with European banks' competitiveness vis-à-vis banks from other jurisdictions.

Already during the debate on the latest revision of the Capital Requirements Directive and Regulation we have pointed to potentially negative side effects of the new framework on the ability of banks to provide credit, hedging services and instruments of trade finance to the European economy. If these instruments become unavailable or prohibitively expensive due to inappropriately calibrated regulation, the consequences will extend well beyond the banking sector. Investment decisions will become less efficient, production or sourcing may be moved outside Europe, and European banks that are currently market leaders in these areas risk being gradually displaced by non-EU competitors.

¹ The view expressed in this paper is based on discussions in the corporate finance and treasury working group of Deutsches Aktieninstitut being the central forum of opinion building on regulatory developments among the treasury departments of the non-financial companies in Germany.

Currently, this is even more relevant as other major jurisdictions, in particular the US, are actively pursuing significant regulatory simplifications, which may place EU banks at a structural disadvantage that undermines not only their own profitability but also the competitiveness of the European companies they serve.

Europe on the other hand, faces a geopolitical environment in which preserving and strengthening the European strategic autonomy is essential for future success. The war in Iran has for instance significantly increased the need for European corporates to hedge their currency and interest rate risks due to the increased volatility.

Ensuring that European banks can competitively serve the real economy is thus not merely a question of financial sector efficiency — it is a precondition for Europe's broader strategic resilience. Already now non-EU banks play a key role in a number of businesses. Though this benefits corporates by having a balanced and diversified spectrum of bank partners a further shift of market shares might reduce European corporates' long term options and create dependency of core financing, financial markets and risk management services. Having a strong European banking sector is thus also a matter of having choices among banks partners for diversifying financing channels, providing risk management capacities and accessing capital markets and investors across the globe.

Making transitional provisions permanent and ensure appropriate supervisory interpretations

Against this backdrop, we are of the opinion that the upcoming report on the competitiveness of the EU banking sector is an opportunity to revisit at least some of the provisions that have been introduced by the latest capital requirements reform in order to ensure that the competitive edge is preserved.

From our perspective this can mainly be done by making existing transitional provisions permanent and reviewing supervisory practices then by revising the complete set of level 1 and level 2 legislation.

More specifically we call for:

- **Permanent reduction of the SA-CCR alpha factor for derivative exposures with non-financial counterparties:** The latest reform of the capital requirements has strengthened the treatment of counterparty risks in derivative transactions. One important element in that respect is the so-called -factor scaling the capital requirement for the purpose of the output floor calculations. This factor is set at 1.0 instead of 1.4 for exposures with corporate end-users in order to allow bank to offer hedging services to corporates at sufficient scale and at competitive

prices, but this provision expires in 2029, with no permanent solution yet determined (Art. 465 (4) CRR). Derivates are widely used in the management of foreign exchange, interest rate and commodity price risks related to the operative business of non-financial companies. Their availability ensures for example that earnings risks in the export and import of goods and services resulting from exchange rate fluctuations are properly managed and counterparty risks related to non-financial companies is reduced. In making the current provision permanent the EU would avoid a 40 percent increase in regulatory capital banks need to provide for these transactions. It also would bring the EU in line with the approach already adopted by US regulators. Based on a calculation performed among 17 non-financial member companies of Deutsches Aktieninstitut in the outset of the latest CRR reform we estimate that phasing out the current transitional provision could result in extra costs for hedging services between 32 to 48 million Euros for p.a. for a set of 17 German companies.²

- Permanent appropriate treatment of unrated corporates:** Deutsches Aktieninstitut has always supported an increasing role of capital market finance in order to diversify the financing structure. An increasing number of companies having an external rating would be one element, if not a condition for this transition. However, most European companies will still have to rely on bank finance as they for example too small to use capital markets efficiently. Consequently, these non-financial companies do not need a costly external rating to signal their credit quality to investors in the capital markets. We also do not believe that it is realistic ratings will be available in a cost-efficient and reliable manner anytime soon for the vast majority of unrated European companies. Capital requirements, however, apply a standard risk weight of 100 percent to the respective corporate exposures according to Art. 122 CRR for the purposes of the calculation of the output floor. This happens irrespective of whether the internal evaluation of the credit quality is more positive. To avoid significant increases in credit costs the current CRR thus rightly applies exemptions from this strict treatment which phases out progressively until 2032 (Art. 465 (2) CRR), again without a confirmed permanent regime. As with the alpha factor above we believe that a permanent solution should be established that better reflect economic realities. Making the current

² See Deutsches Aktieninstitut, Basel IV and the Cost of Hedging for Non-Financial Companies, 13 December 2019. Under the assumption of an alpha factor of 1.4 we calculated a range between 112 and 167 million Euros of extra costs depending on the rating assumptions. As the alpha factor has been set to 1.0 for the transitional period extra costs to be borne by non-financial companies have been reduced by 32 to 48 million Euros compared to the original proposals albeit not eliminated altogether. If the transitional provision is not made permanent, this amount will also have to borne.

approach permanent and communicating about this early on will be essential.

- **Appropriate application of the provisions on trade finance:** Instruments of trade finance (i.e. mainly guarantees for payments) are pivotal for executing international trading flows and related payments efficiently and reliably, thus directly serving the international business relations European companies. At the same time, instruments are typically low risk instruments from the perspective of the bank providing them. After long discussions Annex I of the CRR has accounted for the important role of the relevant instruments and their low risk character by attaching typically a low credit conversion factor of 20 percent to the most common instruments. However, we hear that supervisory interpretations of the relevant elements of Annex I tend to be more strict, so that banks' are asked to apply conversion factors of 50 percent instead of 20 percent in many cases. We believe that this treatment is neither in line with the legal text nor with the political intention. Furthermore, it hurts the international business of non-financial companies. Thus, clarification is needed to avoid making the relevant instruments unjustifiably costly.

Conclusion: Need for fast and targeted reaction in a changing geopolitical landscape

The competitiveness of Europe's banking sector and the needs of non-financial companies being clients of banks are inextricably linked. A regulatory framework that is calibrated in a suboptimal manner or applied too rigidly does not merely affect negatively banks it also may impair the ability of non-financial companies to hedge their risks, finance their operations and to invest in the future. It may also ultimately limit choices for corporate clients thus making them more dependent on the availability of services from a certain subset of banks.

The forthcoming competitiveness report offers an opportunity to address concerns that has already been brought forward in the past but have gained even more importance in a changing geopolitical landscape and in the light of regulatory developments in other major jurisdictions.

We therefore call on the EU Commission to convert the transitional arrangements described above into permanent solutions and to correct supervisory interpretations that produce unintended and disproportionate outcomes, so that the European regulatory framework better supports — rather than risks undermining— the competitiveness of the European economy as a whole

It is also important, that the EU reacts fast, as long-term business is already reaching into 2033 and beyond and thus will be affected by the phasing-out of temporary relief measures. Banks and their clients thus need clarity quickly to be

able adjust to consequences of a potential phasing-out. The European Commission should thus publish a clear package with targeted proposals that directly benefit “corporate Europe” by the end of 2026. This package should then be negotiated fast. This would allow for the European corporate treasurers to maintain availability of choice in their partners during these geopolitical tense times.



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