Subject: Position of the European Association of Corporate Treasurers (EACT) on aspects of the implementation of the final Basel III reforms in the EU

The EACT is grateful for the opportunity to respond to this consultation on the implementation of the final Basel agreement in the EU.

As an association representing the corporate treasuries of non-financial companies (NFCs) we have – in particular since the financial crisis – been supportive of regulatory efforts to increase resilience and shock absorbency capacity in the banking system, and more broadly in financial markets.

We welcome efforts by policy-makers to increase the resilience of the EU financial system but would urge for a careful risk-based assessment of the potentially detrimental impact of the proposed Basel rules on the non-financial sector in Europe.

We would like to focus our comments on three particular issues:

- Preserving the current exemption from CVA charges for OTC derivatives transactions that are exempted from central clearing under EMIR Article 10; and
- Ensuring a careful calibration of revisions to the treatment of some exposures, specifically unrated corporates and specialised lending; and
- Maintaining an adequate capital charge for certain trade finance instruments used by NFCs.

CVA exemption for exposures to NFCs below the clearing threshold (NFC-)

The currently applicable CVA charge exemption is intrinsically linked to EMIR exemption from the clearing obligation for NFCs below the clearing threshold. As such, we are concerned that a removal of the exemption – even a phasing out as recommended by the European Banking Authority (EBA) in its 4 December 2019 report – could have detrimental consequences for the pricing of commercial risk hedging.

CRR introduced in its Article Art. 382 (3) an exemption for CVA charges for OTC derivatives transactions that have been exempted from central clearing under EMIR Article 10. This exemption is intended to support the EMIR central clearing exemption due to the concern that applying CVA charges on the OTC transactions of NFCs below the clearing threshold (NFC-) could lead to an increase in the cost of commercial risk hedging. Imposing higher capital charges through supervisory measures for currently exempted transactions would mean that the effect of the exemption would be largely eliminated. This would cause uncertainty on the market and therefore higher prices and reduced number of bank counterparties for NFC OTC derivative transactions.

We would like to highlight that this exemption is instrumental in enabling EU NFCs to use OTC derivatives to hedge the impact of movements in currencies, interest rates and commodities. EU NFCs rely to a significant degree on risk-mitigating derivatives transactions to hedge commercial risks along their integrated supply chains. NFC's derivatives portfolios do not represent systemically significant risk accumulations as the derivatives used by NFCs are linked to the commercial, value generating real economy activity of the corporates using OTC derivatives for hedging purposes.

Although the CVA exemption for corporate exposures is an idiosyncrasy of the EU implementation of the Basel standards, EU NFCs are for structural reasons more dependent on risk mitigation tools than for instance their US counterparts. Therefore, putting at risk the continued availability of such tools puts EU companies at a competitive disadvantage. This is intrinsically linked to the ability of EU industry to remain competitive on the global stage. For example, most of the relevant global markets that EU companies compete in are primarily dollarized markets and therefore require cross-currency hedging to mitigate commercial risks. Many European-based companies that operate on global markets have local supply and production chains and as a result have to sell their products in a different currency than the one they pay their employees and suppliers in. This in turn renders the cost-efficient availability of hedging instruments even more of a necessity for EU companies than for some of their international competitors

Exposures to unrated corporates and specialised lending

Under the currently envisaged rules, bank exposure to 'unrated corporates' would have a 100% risk weight assigned to them. Given the structure of the EU economy, many EU companies – particularly SMEs – rely on bank-based finance rather than market-based finance and therefore do not possess an external credit rating. The category of unrated corporates is very wide and would also capture companies that are unlisted but would be considered investment grade corporates if listed on a recognised exchange.

We are concerned that a blanket application of the 100% risk-weight for bank lending to such unrated corporates does not take account of the specificities and wide-range of companies who would be impacted by this approach. The absence of an external credit rating is not necessarily indicative of the credit risk posed by individual companies. We would therefore urge for a more nuanced and risk-based approach to calibrating the risk-weights for specialised lending that takes account of differences in credit-risk profiles within the category of unrated corporates.

We would similarly ask policy-makers to factor in potentially adverse impacts on real-economy financing when considering treating specialised lending exposures to non-financial corporates as unsecured loans on bank balance sheets, whereas observable default and loss rates for specialised lending – e.g. project finance, aircraft finance etc. – can be significantly lower than those for unsecured corporate loans.

Capital charges for certain trade finance instruments

NFCs use documentary credit and guarantees to participate in international trade. For instance, when NFCs respond to tenders for large foreign projects, they are often required to post bid bonds to guarantee the reliability of their submission.

At a later stage, if they have won the tender, they are often required to provide performance bonds to guarantee the performance of their products and services.

We understand that the capital charges for these technical guarantees could be more than doubled, while such an increase in capital charges does not reflect the historical default rates.

A significant increase of the price of these technical guarantees could change the economics of a project and potentially deter some companies from responding to tenders.

THE EUROPEAN ASSOCIATION OF CORPORATE TREASURERS

As such, we would ask for a careful consideration of the impact of the proposed changes on the ability of EU companies to participate in international trade.