



Munich Financial Centre Initiative Position Paper on the occasion of the members' visit to Brussels on 2/3 February 2011



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Solvency II

I. Background

- Solvency II is set to enter into force on 1 January 2013. The framework directive was adopted in 2009. Currently being finalised are the so-called Level II measures. Level III measures are in course of preparation.
- The SEG (Solvency Expert Group) was formed at the beginning of 2010. Chaired by the European Commission, this body serves as a forum for finance ministers to discuss the formulation of the implementing measures, of which a revised draft was submitted in October. Now being evaluated and, where appropriate, incorporated into it are the insights gained from the fifth impact study (QIS5). The implementing measures are expected to be finalised in the second quarter of 2011.

II. fpmi's position

- fpmi remains a supporter of Solvency II.
- Whilst Europe's insurers have withstood the crisis, this does not lessen the need for an approach that uses economic and principles- and risk-based models. Now emerging, however, is the concern that the positive approaches laid down in the framework directive might be questioned and even undermined by an excessive level of complexity and additional requirements with the financial crisis being put forward as justification.
- fpmi sees a danger of key aspects not being properly recognised, particularly when determining the risk-free yield curve, the eligibility of economic capital and the scope of reporting obligations, in the treatment of diversification effects and in the over-calibration of credit spread risks. The treatment of hybrid instruments should reflect their economic character and a generous transition period should be allowed for their recognition.



- Yield curve

Depending on how the yield curve is defined, it can have a substantial effect on the amount of the reserves to be discounted and, hence on capital.

Therefore, the yield curve has to be set in such a way that conditions prevailing in the markets are taken into account:

- Employment of swap rates (highly liquid, no pro-cyclicality arising from downgrading).
 - A liquidity premium and a spread over and above the interest rate, because as long-term investors insurers can reap additional profits from investing in illiquid markets.
 - The yield curve has to be macro-economically extrapolated. This has to be undertaken, at the latest, when markets experience shortage of liquidity.
 - The concepts of a liquidity premium and extrapolation have to be reconciled with each other.
- Full eligibility of economic equity – EPIFP (Expected Profits included in Future Premiums).

The market-value principle of Solvency II requires that all risks arising out of the existing insurance portfolio over its entire term be taken into account. CEIOPS (in the future: EIOPA) and several Member States are, however, calling for future profits from the portfolio, especially future premium income from contracts already concluded, to be recognised only to a limited degree as (tier 1) capital. This would lead to these items being treated in an uneven and non-market-consistent way, which would have significant adverse consequences. The current procedure, in which EPIFP is recognised as Tier 1, should be retained at all costs.

- Recognition of EPIFP as Tier 1 capital is self-evident in a system based on market values such as Solvency II and is in line with the full-balance-sheet approach.
- They are profits arising in the future from existing policies, not vague expectations of earnings.
- A system based on market values and the full recognition of risks requires that future earnings also be taken into account.
- The value of these earnings remains intact even in an insolvency.



- Appropriate reporting obligations

The reporting obligations emerging from current deliberations are far too extensive. They go well beyond the Solvency I requirements. fpmi views both the breadth and depth of the information required as going beyond what is needed for a proper system of supervision. Certain information is to be submitted quarterly (instead of annually), including a quarterly listing of all investments at both legal-entity and group level, whereas current practice is to require only aggregated figures. It should be borne in mind that insurers make long-term investments because of the long-term nature of their obligations. The new requirements would require extensive modifications to IT and reporting systems, with considerable expenditure on development and day-to-day operations.

Detailed information should therefore only be required where there are recognisable and clearly defined benefits for supervision.

The depth of granularity should be based primarily on the view of the risk and annual reporting. A clear distinction should be made between regular reporting and reporting required in special circumstances.

- Recognition of diversification effects in group risk margins

The current state of the discussion provides for the group risk margin being the sum of solo ones. This approach does not do justice to the matter at hand and is not compatible with the determination of Group SCR (Solvency Capital Requirements). Diversification effects are totally disregarded, despite the fact that insurance is based on diversification as a matter of principle, both within individual areas of business and across all business segments. The better an insurer's diversification, the less vulnerable it is to risks. A well-balanced mix of premiums in the areas of life, health and composite insurance and the consequent scale of operations are fundamentally positive factors. If different classes of insurance are treated in isolation and diversification effects between the classes are not adequately recognised, risks would be overestimated, as diversification effects between health, life and property-casualty risks would be totally disregarded.

- Credit spread risks

The recognition of credit spread risks is overemphasised in the proposals currently being considered.



- Recognition of hybrid capital

The proposals provide for recognition of hybrid capital as Tier 1 only where there is provision for its automatic conversion into share or basic capital or for the instrument to be treated as retained earnings (via a “write-down”) if the insurer falls materially short of the solvency capital requirements. These narrowly-formulated preconditions require further consideration, however, as such a “write down” does not in fact give rise to an additional inflow of capital, but rather, in certain circumstances, to the reverse because it results in a taxation liability. Market experience has shown that instruments featuring “conversions” are hard to place. Through a moratorium on or cancellation of interest payments and/or of repayments of principal, investors in hybrids also adequately participate in the defraying of losses. The possibility of a moratorium on interest payments and/or principal repayments ought to be sufficient to justify recognition.



Insurance guarantee systems

I. Background

- The failure of several EU member companies to set up Insurance Guarantee Systems (IGS) means that many customers in these states are not sufficiently protected against the risk of their claims not being met in cases of insurer insolvency.
- The EU Commission maintains that the lack of harmonization in this area might hinder effective and equally-strong consumer protection, and that it could lead to a loss of consumer confidence in the relevant markets.
- To preclude this, and in accordance with a recommendation advanced by the de Larosière Group, the Commission has started a consultation process and has issued a White Paper. It is designed to pave the way for an EU-wide harmonization of IGS.
- The White Paper has the following objectives:
 - establishing a framework ensuring a coherency of undertakings by the EU on IGS-provided protection,
 - promulgating a directive ensuring that IGS exist in all member countries and that they comply with a minimum set of design requirements,
 - delineating an approach leading to a minimum level of harmonization.



II. fpmi's position

- fpmi has endorsed the Commission's view that IGS could well be an efficacious tool for the fostering of confidence in the insurance market and for the preclusion of the serious hardships for consumers that would otherwise arise from insurer default. The Initiative also views IGS as being a prerequisite for the allowance of group support under Solvency II.
- IGS could, however, constrain competition and impose systemic risk on markets. These facts mandate their scope's being strictly limited to the assuring of the requisite level of consumer protection. In addition, it should be noted that there is a fundamental difference between the business models applied in the banking and insurance sectors. This difference was revealed once more in the financial crisis.
- fpmi appreciates the White Paper's incorporating a range of ideas advanced by the insurance industry. In particular, we welcome the minimum harmonization approach and the last resort designation, and, especially, the concept of risk-based contributions that express the financial stability of the contributing insurers. This will help blunt the moral hazard issue arising from IGS.
- fpmi does, however, take issue with the Commission's proposal in the following areas:
 - General methodology:

Despite the comprehensive Impact Assessment ("IA"), fpmi feels that the question as to whether any protection is genuinely needed has not been assessed carefully enough, with this particularly applying to non-life insurance.

The IA launches its making of the case for IGS by citing such 'facts' as 0.50 defaults per year are the norm in Germany, with this figure rising to 2.0 per year under high-stress conditions. This radical statement is not justified by a plausible methodology. It is simply arrived at by taking the (EU wide) probability of default and multiplying it by the number of insurers. This is, to the best of our knowledge, not supported by historical data. Not a single insurer in Germany failed during the past two years (during which time no governmental support was provided). This unlikely eventuality has been provided against by the establishment by German life and health insurers a long time ago of the Protektor and Medicator policy guarantee companies.



- Coverage of non-life insurance:

fpmi cannot see how the alleged loss potential in non-life insurance business was calculated. We are sceptical as to whether IGS are really needed in the non-life business. We are in fact convinced that they are not required to cover unearned premiums.

Neither of the two core objectives of IGS is germane to the non-life business. The goal of fostering market stability and confidence does not apply to it because there can be no general loss of either. Unlike banks, runs on non-life insurers are not possible, since demands for recompense only arise upon the incidence of damages.

The second goal of the IGS is enhancing consumer protection. We strongly hold that this need would only arise in cases in which existence-threatening – in that the insurer would be no longer capable of settling them – damages occurred. This failure would not encompass unearned premium. In this area, there is simply no equivalent to the accumulation of savings that would justify the scope of protection accorded to life insurance or to banking's deposit insurance schemes. We are aware that the Commission is preparing to consider compensation limits. This, however, does not indicate whether or not the Commission agrees with not covering unearned premium. Nor does it reveal how the loss potential is to be calculated.

- Eligible claimants:

fpmi does not accept the inclusion of SME policyholders, along with consumers, in the ranks of eligible claimants, as doing such would obviously not further the objective of improving consumer protection. We see this – rather than furthering the interests of enterprises – as being the objective of such regulations.

In addition to this lack of fundamental pertinence, the proposal also would place an undue burden upon the insurers and IGS. The calculation of the contributions requisite for the underwriting of policies held by SMEs would force the IGS or insurers to identify the technical reserves established for the companies. This would seem to give rise to further encumbrances.

- Design of the funding:

The White Paper strives to refute the position that ex-ante funding would pose an encumbrance to insurers and the insured. We are maintaining this position, and find it especially important in a time in which neither group needs a further burden. The Commission does admit that this form of IGS funding would be more expensive. It is for these reasons that fpmi is strongly calling for the



authorization of ex-post funding, and for ex-ante to being limited to continuity IGS (those which cover portfolio transfers).

We advocate a three-pronged approach to the calculation of contributions: (one) taking into consideration the insurer's amount of technical reserves, as it precisely depicts the business underwritten by the insurer and pays due regard to the past; (two) using GWP to adequately factor in the insurer's liquidity; (three) weighting contributions by risk. The latter is the most important yardstick.

- No transnational insurance guarantee system

The difference existing among products and – quite pronounced – national-level accounting regulations as well as the extant security-ensuring mechanisms make it essential to avoid offering transnational protection while achieving the establishment of a single and unified system of insurance guarantees. A failure to do such would put insurers which calculate premiums conservatively and include provisions for eventual insolvency at a disadvantage vis-à-vis „aggressive“ competitors. This would give rise to the peril of the moral hazard posed by imprudent markets initially attracting business and premiums from conservatively operating ones. The latter in turn would be subsequently called upon to bear the costs of returning the former to financial health.



Green Paper on pensions

I. Background

- fpmi highly welcomes the Green Paper and the intention of the European Commission to initiate a discussion on how Member States can be best supported in the achievement of the agreed-upon goal of assuring that all citizens of the EU have adequate and sustainable pensions. The Green Paper provides an important basis for this discussion, as it draws a realistic and non-ideological picture of the challenges Europe's pension systems are currently facing. A European discussion about appropriately-sized, sustainable, viable and affordable pension systems is meaningful and necessary.

II. fpmi's position

- Adequate and sustainable pensions

Despite the fact that the reforms of the last decade have introduced a variety of measures to foster private old age provision, there is still no consensus as to what constitutes “adequate”. A pension system can be viewed as a qualified pool of assets whose purpose is to generate future income. A multi-pillar system would turn this pool into a portfolio capable of engineering diversification among the pillars. The variety existing among types of risks would be accounted for by a similar variety of pension plans and of retirement-use savings, not all of them necessarily covering all the risks, or all the risks in the same way. By coming up with a clearly-defined and quantitative set of tools measuring the adequacy of a pension system, it will be possible to optimize investment strategy and to deploy the multiplicity of pillars to its best advantage. Such tools could be used to properly gauge the respective pillar's risk tolerance, the system's liability characteristics and the attainability of investment targets. A wide range of criteria, many specific to individual systems and economies, is used to determine the adequacy of retirement income. This fact means that “adequacy” has to be expressed in relative terms.

In order to better define what an adequate retirement income might entail, the scope of instruments used in providing old-age provision should be limited to products offering security (against loss of capital or insolvency) and featuring dedicated use (in old-age provision itself, in the maintenance of assets). Such instruments can well have optional biological and demographic components and could entitle beneficiaries to life-long payments. National legislation may provide delimited capitalized benefits.



As a general rule, the standards of maintenance now in force in funded old-age provision systems already adequately protect their members and beneficiaries against possible losses of their retirement assets and pension cuts, and thus against poverty. These standards also protect the Member States - to a large degree - against the possible need for a bailout. However, the pension systems in Europe's countries continue to show substantial differences among each other, and are still very much national-level in focus. These differences and focuses give rise to the inability of the EU-level's pension framework to foster sustainable public finances. As the downturns in financial markets and the increase in public debt have clearly revealed, the public-sector finances of most EU member countries require diligent supervision and improvement. One deficiency of the framework stems from the methodology used in the EU in the calculation of public debt (stability and growth pact). This is of crucial importance as the current framework is thus unfavourable for those EU members that have already decided to make reforms in pension systems (CEE countries).

- Work and retirement

Pensionable ages have to be increased to account for the rises in life expectancy and in periods of education. The latter joins with the maintenance of ages of retirement in cutting lives of work. The ratio of working life and of retirement has to be rebalanced. Raising the age of retirement will benefit all pillars and systems. It will also reduce the pressure on public finances and on fiscal policy, thus improving the sustainability and the adequacy of the system in the process.

These benefits could well be produced by instituting automatic adjustment mechanisms linked to demographic changes and based on measurable indicators. The thrust of the EU's policy-making should be allocating responsibilities and empowerments in ways obliging the Member States to achieve a broad-based alignment of their legislation. To this end, fpmi fully supports the implementation of the Europe 2020 strategy, which promotes the employment of older workers.

- Removing obstacles to mobility

Differences in tax, social security and labour laws constitute the most serious obstacles to mobility, as they give rise to differences existing in the parameters applying to occupational pensions in the Member States. These differences have to be addressed by the schemes enacted by the EU, which should set up single sets of fiscal, functional and organizational regulations. The regulations should especially deal with the issue of continuance of pension entitlements in the case of a change of the country of employment. The regulations should also establish rules on the transferring of accumulated pension capital between pension institutions in two or more countries. To be avoided while doing such is the incurring of excessive burdens to be borne by employers' and pension carriers.



Measures designed to facilitate such transfers should be considered carefully. In any case the improvement of the standards applied to the acquisition and preservation of pension rights needs to be addressed. The institution of a comprehensive and transparent tracking system would be a good idea, as it would provide the beneficiaries with a comprehensive and realistic picture of their future provision. The standards of such a system have to be formulated carefully, however, to preclude the dissemination of faulty information.

- Safe and transparent pensions

To ensure a consistency of regulation of funded pension schemes and of products, the legislation enacted by the EU and its Member States has to be revamped to account for the changes gripping markets and ensuing from demographics. A solvency regime on second and third pillar pensions has to be based upon the formulation of a ‘common language’ for all pensions. It has to manifest the long-term nature of pensions and of the investments funding them. A single set of solvency rules and standards has to apply to products that cover the same risks. The differences existing in the risk exposures faced by old-age provision products have to be accounted for by formulating individual-class solvency requirements. It should be noted that solvency rules and insolvency protection systems each have distinct and non-offsetting roles to play.

The EU – quite correctly - views the Solvency II framework for insurance companies as being a role model for a solvency regime for institutions for occupational retirement provision (IORPs), thanks to Solvency II’s focuses on risk-based and risk-adequate regulations and requirements. The EU’s policy-making should be guided by the awareness, however, that it will not be possible to simply use both the Solvency II regime and its quantitative requirements as a template for the regulating of all pension providers. A further point to be considered is that the current draft of the Solvency II framework would give rise to inadequate capital requirements and excessive financing costs for insurers. These moves would endanger the affordability of life insurance products. The first step thus has to be the revamping of these stipulations.

Furthermore, a solvency regime for pension funds has to take into proper account the diversity of pension schemes and of ancillary security mechanisms protecting occupational pensions in force in the Member States. The objective is to prevent an overburdening of the IORPs. Applying the Solvency II framework to occupational pension funds without making adequate modifications would probably lead to an increase in financing costs for employers. This would further reduce their willingness to support traditional and hybrid defined benefit plans. The protection provided by EU legislation against insolvencies experienced by employers that are sponsors of pension plans appears to be sufficient in most Member States, and therefore should not be beefed up.



- Governance

The formulation and implementation of tax and societal policies lies in the province of the Member States. Despite this, the institution of an EU-level framework leading to the coordination of pension policies would have the beneficial effects of giving rise to a more integrated approach. Beneficiaries would be both the systems and the pension savers themselves. Also beneficial would be the formulation of a book of binding definitions.



CRD IV / Basel III; cumulative ramifications of regulations currently being enacted

I. Background

- The focus has been placed on stiffening the requirements placed on the quality and quantity of the equity held by banks and on instituting the LCR (liquidity coverage ratio) and NSFR (net stable funding ratio) key indicators.
- To limit the level of bank indebtedness, a leverage ratio is to be introduced. As this key indicator is not risk-based, the adding of it will foster a shift from such low-risk business as governmental and mortgage-based transactions to business with higher risks.
- The EU Commission has proposed the replacement of liable equity (core and supplemental capital) by core capital (Tier 1) in the calculations of the limits of large-sized loans. This would expedite the reaching of this limit.

II. fpmi's position

- The effects of Basel III upon banks and upon the economy as a whole have to be ascertained by placing them in the context created by the other reforms planned for financial markets. These include, among others, the alteration of deposit guarantee systems, and the instituting of bank charges and of the financial transaction tax. The latter, in turn, will impact upon Basel III. This mandates – with this to be undertaken prior to the promulgation of directives – **the conducting of a painstaking investigation of the collective impact of the measures upon the banking sector, upon the real economy, and upon the public sector finances on both the national and global levels.**
- To ensure the fairness of competition, Basel III must be implemented simultaneously in the EU and the USA. In addition, all differences in the ways the EU and the USA calculate equity have to be eradicated. As is well known, it was not until the end of September 2009, at the G20 summit in Pittsburgh, that the USA committed itself to implementing Basel II by 2011 (EU: 2008). An international-level synchronicity in strengthening bank supervision systems, as stipulated by Basel III, is, however, a key requisite for the attaining of a **“level playing field“**. A failure to do such would give rise to a “patchwork” of regulations yielding ways of performing arbitrage among supervisory systems, and thus causing distortion of competition among international financial centres. Because a relatively large share of its business’ financing stems from loans, Europe would be doubly penalized when having to fulfil the requirements to maintain larger amounts of equity.



- Basel III will increase Germany's need for hard core capital by 73 billion €. This need cannot solely be met by reinvesting profits or by transforming silent participations into share capital. This is especially because Solvency II will cause the investments made by insurers to be cut back, and because financing will have to be procured to satisfy the costs of other planned measures. In cases in which the reinvesting of profits and transformation of reserves are not possible, the results will be an increase of the costs and a reduction in the amounts of loans. These developments, in turn, will yield drops in profitability. The measures will give rise to structural changes whose ramifications will be felt by the banking sector, by businesses in general, and by their staff members.
- A way of getting some form of a grip upon this greater need for equity capital, and with this not to depend upon the legal form in force for the bank, is to retain the recognition of **silent participations** as being hard core capital. There are no factual reasons for a dichotomy of classification between those silent participations invested in banks that are not incorporated as joint stock companies and those consigned to institutions whose legal form is that of a joint stock company. The determinant factor should be the nature of the capital instrument.
- The Basel Committee has proposed the partial deduction of **deferred tax assets** from hard core capital. The Initiative rejects this proposal, as the recognition of such taxes in balance sheets has a substantial counter-cyclical effect and is thus beneficial for the economy as a whole – as recently shown by the financial crisis. A further aspect speaking against the proposals is they raise the spectre of a serious discrepancy of treatment between banks in Europe and in the USA, in which a netting of deferred tax assets and liabilities (DTA vs. DTL) within a tax jurisdiction is permissible on balance sheets, and in which the only deduction required would be any excess of the former.
- The Basel Committee and CEBS have joined in endorsing the principle of recognizing **credit union share capital** as core capital. A CEBS guideline promulgated in mid-June 2010, however, requires the option to be possessed by both executive and supervisory boards and by the responsible supervisory body of rejecting the termination or repaying of these shares (with this especially applying to situations of inadequate equity backing). Urgently required are rules of transition applying to the implementation of changes on the national level of articles of association.
- Art. 37 para. 2 of the Banking Directive, which is implemented in Germany by § 340 f of the country's Commercial Code (HGB), provides banks with the option of constituting **prudential reserves for general banking risks**. According to § 340 f HGB and Art. 63 of the Banking Directive, non-tied undisclosed reserves are entitled to be classified as supplementary capital. Undisclosed prudential



- reserves proved their value during the financial crisis, in which they served as counter-cyclical buffer capital. Both Basel III and CRD 4 require a comprehensive disclosure of all components of equity. This would constitute a rescinding of the recognition accorded to undisclosed prudential reserves. This fact is behind the Initiative's calling for a retention of the status quo.
- The promulgation of the new equity regulations has to be accompanied by the enactment of **grandfathering regulations** sufficient to preclude any distortion of the supplying of credits to businesses. A role model could well be CRD II's regulations on hybrid capital, which will take effect as of the end of 2010. These stipulate that legacy issues not fulfilling the stipulations of the new regulation are to be accorded complete protection through grandfather provisions for the first ten years after promulgation of the new act. This protection will be lessened on a step-by-step basis until ceasing entirely in 2040.
 - The final forms of the **Liquidity Coverage Ratio (LCR – with a 30 day timeframe)** and **Net Stable Funding Ratio (NSFR – with a year long timeframe)** have been established by the Basel Committee. These key indicators of liquidity will be employed to detect shortfalls of liquidity being experienced by banks in phases of stress. fpmi is a supporter of the regulatory authorities' plans to conduct impact studies yielding practicable results and to extend a phase of observation from 2015 until 2018 prior to promulgating these key indicators. This support stems from the possible consequences the indicator could have upon the management of liquidity and thus upon the capitalizations of the banks and their abilities to supply loans. The findings of the comprehensive quantitative impact study conducted in 2010 by the Basel Committee for Banking Supervision (BCBS) and by CEBS (Committee of European Banking Supervisors) establish that the fulfilment of liquidity rates will require the large-scale replacement of mortgage bonds and other items by governmental bonds. fpmi takes a critical view of this possible development. The implementation in a EU-level code should lead to mortgage bonds and other first-class corporate bonds' being fully recognized as liquidity. This, in turn, would cause them to be categorized, as is the case with governmental bonds, as being highly liquid assets.
 - A **leverage ratio** constitutes at best an issuer of a warning signal to be heeded by supervisors of banking operations. Establishing it as a hard ceiling as part of the initial pillar of Basel II (minimum quantitative requirement) does not represent a suitable way of getting a better grip on risks, as the USA's track record shows. The differences prevailing among international standards of accounting would, in addition, cause the introduction of a leverage ratio to be accompanied by a considerable distortion of competition. To be strictly rejected is an automatism causing the migration to Pillar One in 2018. From today's vantage point, fpmi is calling for a lasting anchoring in Pillar Two.



- The **large-sized loan regime's** reduced capital base would curtail a bank's capacity to make loans despite unchanged loan exposure. Also, banks would run the risk of exceeding the ceiling placed on the provision of large-sized credits for which they would have to secure the approval of supervisory bodies and of having to deduct capital. The regulations on large-sized loans threaten to join the stiffening of stipulations arising from CRD II (with these including the cessation of the according of privileged status to loans made to banks, and the stiffening of the definition of risk units to include considerations of business dependencies) in bringing about a credit crunch. These facts form the basis of the Initiative's call for the retaining of both core and supplementary capital as factors to be used in the calculation of the ceilings for large-sized loans.



The regulation of financial markets: encumbrance for the real economy

I. Background

- The contours of the regulation of financial markets are gradually beginning to emerge. Also becoming clear at the same time is that there will be a price to pay for this body of regulations. This price will take the form of a reduction of the market volume of certain forms of financing and of a stiffening of their conditions. Affected by these trends will also be the real economy to an extent yet to be calculated.
- The result will be a decrease of the real economy's own and outside financing brokered by the banking sector.
- This will especially affect SMEs (small and medium-sized enterprises), since they generally do not have access to the alternative sources of financing provided by capital markets.
- For insurers, new accounting regulations will tend to lessen the attractiveness of investments in shares and bonds. This, too, will have corresponding effects upon the real economy.

II. fpmi's position

- Requisite is the clarification of the areas and extents of impact of the new regulations upon the methods and the conditions of financing by the real economy. This is due to companies' possible need to respond to these alterations by expeditiously adapting their business models. To enable the real economy to purposely revamping its financing models it is not sufficient to merely depict the impact of the resultant encumbrances on GDP growth rates for the economy as a whole. Requisite, rather, is the compilation of scenarios of encumbrance specific to typical categories (for instance: subscribers of large-sized loans, SME-level manufacturers and service providers, and internationally-active corporations). These scenarios would enable individual companies and their providers of capital to gauge the extent of the effects of the alterations, and to thus establish how their models of financing need to be changed.
- To be avoided is the regulations' having a cumulative effect constituting an inappropriately-sized encumbrance upon the real economy. The emergence of such a prospect has to be dealt with by altering the regulations.



- Also to be avoided is the retraction by individual countries vis-à-vis the EU of their regulatory approaches. This would be impelled by the countries' appraisals of the impact of the issues listed above, or by their being dependent upon financial markets' achieving high rates of growth. Such retractions would provide the countries' companies with significant cost advantages over their competitors in Europe.
- Conversely, it has to be ensured that similar or even the same regulatory yardsticks apply in markets outside Europe. A failure to ensure this would cause Europe's financial industry to experience a strong disadvantage when competing for business on the international level. To be considered is that Europe would do itself a disservice if it simply implemented American proposals – in an attempt to curry favour – especially if the USA should then fail to follow suit. Case in point: the Financial Crisis Responsibility Fee. This idea originated in the USA, which then did not implement it. This did not stop European countries from taking up the proposal. This, in turn, is causing the financial institutions affected by it to experience considerable disadvantages of competition on the international level.

A similar situation could come into being in the case of the imposing of regulations upon so-called systemically-important financial institutions. Employing a very rigid approach, FSB is currently and intensively devoting itself to compiling the criteria to be used in determining this importance. US Treasury Secretary Geithner recently voiced the opinion that whether or not an institution is systemically important can never be established on a prior basis. This determination, rather, would depend upon the nature of the shock and the economic situation as a whole, in his opinion. He added that size alone does not suffice to constitute systemic importance. These remarks intimate that the USA could well be “retreating” from its previous position.

- The regulations have to be reconciled with each other. This process cannot be subject to unwarranted time pressures.
- The following remarks list the encumbrances concretely impacting upon the real economy and requiring a determination of their collective effects:
 - CRD II, CRD III, Basel III / CRD IV and Solvency II: limitation of the volume of large-sized and other loans; worsening of their conditions of provision; increasing of the costs of hedging and securitization transactions; and limitation of the financing provided to banks and to manufacturers by insurers.
 - Financial transaction tax: charging on of costs to customers; immediate encumbrance of customer-related and hedging transactions; increasing of costs of capital market transactions through lessening of liquidity.



- Financial activities tax: passing on of encumbrances to markets, and curtailing of the banks' loan-making capabilities through their impaired ability to generate equity.
- Bank charges: passing on of costs to customers; alteration of banks' business models (pushing commission-yielding business and thus pulling back from loan-based transactions; cutting back on leasing), thus giving rise to the accompanying ramifications upon markets.
- Derivatives, securitization: increasing of costs of hedging; stiffening of conditions resulting from lessening of market liquidity; possible extending of regulations applying to financial companies to large-size businesses, with accompanying effects on costs.
- Deposit insurance: impairing of equity positions held by banks and hindering of liquidity management, in accordance with Basel III due to the withdrawal of deposits; exacerbating the encumbrances from Basel III borne by the real economy.
- New accounting regulations: IFRS 9 and IFRS 4 Phase II lead, for instance, to a significant increasing of the volatility in the insurers' financial statements. This will cause them to tend to reduce their holdings of stocks.
- To be encompassed by the appraisal of the effects of the regulations are both the cumulative encumbrances as well as impairments affecting the financing of the real economy that ensue for instance from the mutually negating ramifications of the individual measures (such as those of the bank charge and of the increasing of equity mandated by Basel III).
- To be considered are the encumbrances that will be felt immediately by the real economy, such as the burdening of hedging transactions undertaken by companies trading on the international level. Not to be underestimated are the effects of tax increases undertaken to consolidate budgets.
- In many areas expertise from the appraisal of individual measures should permit the European Commission to achieve consolidated assessments. Requisite in the remaining areas – with these especially including bank charges and the effects of changes in tax laws - will be the Commission's calling upon the knowhow possessed by the Member Countries.



Revamping of MiFID

I. Background

- On December 8, 2010, the European Commission published the consultation paper on the revamping of MiFID, its directive on financial markets. The paper's title is "Public Consultation – Review of the Markets in Financial Instruments Directive – MiFID". Statements on the paper can be submitted to the Commission until February 2, 2011. Some of fpmi's members are preparing comprehensive statements for submission. The need not to exceed the parameters of this position paper requires us to confine our comments on the consultation paper to a few key points.

II. fpmi's position

- We support the alignment of the regulation's applying to multilateral trading systems ("MTFs") with those in force for regulated markets (Clauses 2.5 and 3.3 of MiFID Review).

The implementation of MiFID has been followed by the constituting of a large number of multilateral trading systems not forming part of traditional stock exchanges and taking up a substantial portion of the latter's liquidity. This disadvantage has been accompanied by the former's use of the prices and quotes arising and issued on the latter as points of reference. Those stock exchanges in Germany operating both regulated markets and OTC segments (in the form of MTF) remain subject to the strict regulations assuring the protection of investors and consumers. The thrusts of these regulations are the monitoring and documentation of trading and the issuing of instructions guiding markets (such as ones suspending trade in the wake of an ad hoc bulletin). As a rule, no distinction is made between the trading on regulated markets and that on OTC ones. The ever-greater importance (as expressed in the growth of their market shares) of non-stock exchange MTFs urgently necessitates the beefing up of the level of regulation applied to these trading platforms. The protection of the interests of investors and of fair competition demands the adherence by non-stock exchange MTFs to the standards in place for stock exchanges.



Finanzplatz München Initiative

- fpmi hails the initiative to increase the attractiveness of capital markets to small and medium-sized enterprises (SMEs) contained in Clause 2.6 of the MiFID Review.

The crisis gripping financial and other markets has joined Basel III in making capital markets an increasingly important source of corporate financing (own and outside capital) for SMEs and for other companies. While this has been occurring, the level of regulation applying to publicly-listed SMEs has been continually raised over the past few years. This poses the fundamentally-important question of whether or not regulations applying to financial markets and configured with large-sized publicly-listed corporations (blue chips) in mind should pertain to SMEs. The effects have been that virtually all IPOs undertaken by this class of companies in Germany over the last few years have been in the OTC segment, and that a large number of companies have switched their listing from regulated markets to this segment. The above details the growing importance of OTC for SMEs. This importance is being accounted for in Germany by the Munich Stock Exchange's m:access segment and by Deutsche Börse AG's Entry Standard. These special-use segments feature accounting standards and quality requirements configured to meet the needs of SMEs. Such initiatives have to be fostered.

- The EU Commission has established the goal of employing regulations assuring transparency to impart to market players a great capability of recognizing (Clause 3.4) suitable market prices. This, in turn, will enable the players to make on their own decisions on investments. fpmi fundamentally approves of this objective. A final statement may be issued on this subject by the Initiative. For the time being, fpmi is restricting itself to pointing out the need to avoid subjecting such tried-and-true instruments as bearer debentures issued by banks (the vast majority of these are bought and sold according to fixed prices, thus making stock exchange-based trading less important) to further cost-related encumbrances.
- fpmi has come out against classifying CO2 emission rights as financial instruments (Clause 5.4 MIFID Review).

In a contrast to the derivatives issued on the basis of such rights (for instance: the futures and options traded in dedicated transactions), this spot trading does not display any of the complexity justifying its being categorized as a transaction requiring supervision by financial market supervisory bodies. The goal of the cap-and-trade mechanism created to foster, under the auspices of the ETS program, the trading of emission rights in the EU is the encompassing of all companies issuing emissions in this trading. SMEs are also required to undertake measures enabling them to meet their commitments to reduce emissions. This compliance takes the form of selling those rights that they do not require on secondary markets, or of purchasing, in cases of exceeding of ceilings placed



- on emissions, further rights. The classification of spot rights as being financial instruments would exclude companies – such as those emitting low volumes of emissions - required to comply with these rules but lacking the status of being providers of financial services from participating in their own right on secondary markets. They would thus be forced to use the services of intermediaries. Doing such would make the mechanism more complicated and expensive. It would also place companies not maintaining the status of being providers of financial services at a disadvantage. The cases of fraud involving transaction taxes and cross-border transactions mandate the pursuing of the harmonization of the various codes of turnover taxes extant in the EU, the fostering of trading on stock exchanges and the setting up of central counterparties (CCP).
- fpmi places special importance upon the topics raised in the consultation paper on the protection of investors and on the adaptation of the legal parameters applying to securities-related services (Clause 7 MIFID Review). A conclusive evaluation can only be rendered by fpmi towards the end of the term of consultation. An initial appraisal has, however, given rise to the following statements:
 - A cutback of the exceptions accorded to certain players on financial markets receives the Initiative's basic approval. fpmi is especially calling for extending the coverage of system of securities supervision to encompass the "grey" (non-regulated) market.
 - The option of conducting transactions without the services of an advisor has to be maintained. Its costs make the operation of a network of offices staffed by consultants in non-urban regions no longer realistic. The need for this option is also derived from the lack of harmonization prevailing in Germany and involving the special regulations applying to investment consulting.
 - Provided that an adequate level of transparency be attained, both fee and commission-based consulting services should remain permissible.
 - To be retained is the system of classifying of customers, as neither the customers themselves nor the institutions have experienced any problems with this practice.
 - fpmi supports the objective of improving the documentation of the quality of execution evinced by the various trading platforms (Clause 7.2.7 MIFID Review).

The ways in which the 'best' – in terms of quote quality, speed and probability – execution of customer orders is actually performed in daily operations are to be taken more strongly into account. Currently being assumed in the large number



of “best execution policies” is that the quality of execution per se is the same on all relevant trading exchanges, and that, for this reason, the exchanges’ costs constitute the only relevant criterion of evaluation. A critical look has to be taken at this assumption.

Concrete data is to be employed in the formulation of best execution policies; any abstract data used as a basis has to be verified. Also to be taken into account are the differences in the market models employed by the exchanges. Encompassed in this is the consideration of whether specialists or market makers issue binding quotes or indicative values. This impacts upon the reliability of the information supplied to the consumer and upon the probability of the execution at the price detailed.

- fpmi has come out strongly against a requirement to record telephone calls (Clause 8.1.2 MIFID Review), as this would constitute a great and disproportional encumbrance for institutions maintaining networks of offices. Issuing from supervisory law, this requirement would yield structural policies whose enactment would come at the expense of private customers used to having providers of financial services in their immediate vicinity.



Regulation of OTC derivatives (draft regulation)

I. Background

- At the G20 summit held in September 2009 in Pittsburgh, the heads of state and government reached the agreement that all standardized OTC derivatives will be traded on securities exchanges or electronic platforms by no later than the end of 2012. This agreement also foresees OTC derivative contracts' being registered with trade repositories. The agreement also increases the capital requirements for transactions that are not cleared centrally.
- In September 2010 and following two rounds of public-access consultations, the EU Commission issued a draft regulation. It covers OTC derivatives, central counterparties and trade repositories, and is designed to reduce default and operational risks, to enhance transparency and market integrity, and to increase the efficaciousness of market supervision.
- The key points of the draft regulation are the following:
 - qualifications for clearing obligations (Article 1 and 4 of the draft regulation),
 - registry obligations for OTC derivatives (Article 6 of the draft regulation),
 - risk-reducing techniques to be applied to OTC derivative contracts not cleared via CCPs (Article 8 of the draft regulation),
 - requirements to be met by central counterparties (CCP) (Article 10ff of the draft regulation),
 - conditions of authorization for trade repositories (Article 51ff of the draft regulation).



II. fpmi's position

- fpmi supports the principles of the EU Commission's regulatory initiative, which is designed to enhance the robustness, transparency and efficiency of the market for OTC derivatives. fpmi especially endorses the expanding of clearings undertaken by the CCPs to encompass a greater range of standardized financial derivatives, and the registration of these transactions with trade depositories. By bringing about the use of techniques lessening the risks posed by transactions that have not been centrally cleared and by reducing encumbrances upon capital by promoting centrally-cleared ones, the regulation will also create incentives to achieve smoothly functioning and stable financial markets.
- fpmi is in favour, as stated, as of the regulation's main objectives and of most of the stipulations contained in the draft regulation. A number of other stipulations do, however, give rise to concern, or could be better expressed or be improved. Here are our suggestions.
- The most important factors to be taken into account when determining the suitability for the clearing obligation:
 - willingness to clear through suitable CCPs,
 - compatibility with automated settlement procedures; CCPs' having suitable risk management systems,
 - adequate amount of liquidity on markets,
 - product class / market participants (taking into account the highly variegated market structures prevailing for the various classes of products).

The overriding objective should be the assuring of the operation of a risk-commensurate clearing capable of maintaining control over systemic risks. The ancillary goal is the achieving of this in an efficient way. To achieve these goals, ESMA should be equipped with extensive powers, of which one would be the issuing of guidelines ensuring the requisite consistency and uniformity of interpretation of the directive 2004/39/EC, appendix I, section C Nr. (4) to (10) – and, via that, of the area of technical application (Article 1 paragraph 1 of the draft regulation). These guidelines of interpretation should be binding solely for the purposes being addressed by the regulation. Because of the major role played by technical standards in enabling the practical implementation of these new obligations input for the development of these standards should be secured from market players at the earliest possible time. For this reason, public-access consultations should accompany the development of the ESMA standards.



- Limitations of the area of application: fpmi is calling for the excluding of certain kinds of derivative-based transactions from the obligation to be cleared by CCPs:
 - Derivatives deriving from insurance risks:

Case-in-point: CAT bonds. The structure of these bonds compels collateralizing that is not restricted to a margin payment, but which, rather, completely covers any claim for payment arising from the derivative. Such bonds do not give rise to systemic risk. A fact applying to insurance derivatives is that they are not traded on a liquid market, allowing for an ongoing and transparent setting of prices. Margining would also require the guaranteed capability of reliably valuating derivatives on a regular basis. This would pose a problem for many kinds of insurance derivatives.

- In-group transactions:

The clearing of in-group derivatives via a CCP/securities exchange could lead to a drastic expansion of group balance sheets. This would occur in cases of large-sized derivative positions classified as being external transactions' no longer being subjected to group consolidation. The expansion would arise from a derivative-based item's being 'rolled through' two or more reporting bodies within the group. Also not making sense in in-group transactions is the concept of collateral. The routing of in-group transactions via two or more reporting bodies could lead to a group's repeatedly having to deposit collateral with a CCP/securities exchange for one single derivative-based transaction.

- Part and parcel of the obligation to register transactions with a trade depository is the transmission of personal data and of – possibly – highly sensitive business secrets. Each abuse of this information could have highly and far-reaching negative consequences for the market players affected. For this reason, the regulation has to assure an adequately high level of protection for these items. The achieving of this level should therefore be a key criterion for the recognition of a trade depository maintained in a third-party country.
- The requirements to be established for CCPs have to both yield robust owner, risk and management structures – and to take extant legal conditions into adequate account. A failure to do such would give rise to unacceptable legal uncertainties as to the effectiveness and enforceability of the stipulations and the processes applying to the CCP. These comprise the delimitation of assets and obligations held and entered into by clearing members and their customers. They also encompass the transferring of positions in cases of the occurrence of certain ex ante-defined kinds of events, with this particularly applying to the insolvency of a member. Such a legal uncertainty would, for instance, emerge in cases in



which a liquidator, employing the appropriate legal codes, would contest the transfer, or would lodge claims for compensation. Article 37 para. 5 is, for this reason, indispensable. Requisite is, however, also the predefinition of triggering events. Doing such would impart the necessary legal security to the range of the protection granted by Art. 37 para. 5.

- In its current formulation, Article 3 para. 1 of the draft regulation mandates the automatic encompassing of all counterparties in third party countries in the clearing obligation, even in those cases in which they are non-financial counterparties, as stipulated in Article 7 para. 2, whose transactions do not exceed the threshold set in Article 7 para. 2. This stipulation would mean that a bank located in the EU could only enter into business with a company not based in the Union in those cases in which the latter would be prepared to avail itself of a CCP. The converse would be that non-financial counterparties would be entitled to conclude transactions (not exceeding the threshold set in Article 7 para. 2) not involving any clearing by CCPs with banks not based in the EU. Such practices would flout the thrust and purport of the draft regulation, and would also greatly impair the viability of Europe's banking industry. The clearing obligation stipulated in Article 3 para. 1 should be limited in case of counterparties from third party countries to those that are deemed to be identical to counterparties (both financial and non-financial) as defined by Article 7 para. 2.
- fpmi places a great deal of importance on the obligation to grant non-discriminatory access to the CCPs. Achieving this requires the authorization of all of the standardized contract documentation currently being used by counterparties. CCPs should be prevented from accepting a single kind of contract documentation (for instance: the ISDA Master Agreement), as this would result in the favouring of a single and underlying legal code and of a sole contractual language. To achieve this, Article 5 of the draft regulation also has to cover discrimination arising from the choice of contract documentation. Otherwise there would be a risk that recognized contract documentation in standard use on markets' – such as Germany's framework contract for financial futures – might no longer be employed.



Regulation of short selling

I. Background

- No single set of EU-level regulations applies to short selling. In response to this lack, Germany and other member countries have recently undertaken to restrict or even forbid short selling-based transactions by means of legislation and / or administrative measures.
- As a result, the EU Commission has launched a legislative initiative. Its objective is to establish a standard set of rules for both short selling and similar kinds of transactions.
- The thrust of this initiative is formed by the draft regulation recently submitted by the Commission. It applies to both short selling and to certain aspects of credit default swaps.
- The key points of the draft regulation are:
 - prohibition of the short selling of stocks and of public bodies-issued debt instruments, except in those cases in which the paper being sold is backed by a lending of securities;
 - attaining of a higher level of transparency by requiring:
 - the reporting to (a) supervisory body (bodies) and, if required, (b) to markets (disclosure) of net short selling positions held in shares when exceeding a certain threshold,
 - the reporting to (a) supervisory body(bodies) of net short selling positions held in public bodies-issued debt instruments,
 - the flagging of all orders to short-sell shares.



II. fpmi's position

- fpmi approves of the principles informing the initiative being undertaken by the EU Commission to formulate a regulation. fpmi has repeatedly stated its view that short selling, with this especially applying to uncovered transactions, can – when taking place in times of unfavourable conditions - considerably endanger the functioning and stability of financial markets.
- Urgently required is thus the hindering of such potentially dangerous transactions and the enhancing of their transparency. The draft regulation submitted by the Commission constitutes in the opinion of fpmi an effective way of precluding intra-EU evasive tactics and distortions of competition. The regulation thus represents a way of establishing a level playing field for this area.
- The track record produced by the recent changes in Germany's Securities Trading Act and by the corresponding adaptations of operations undertaken by the players in the German market is causing fpmi to call for a modelling of the European-level standards upon Germany's new legal code and situation. This code represents the optimal way of satisfying the needs to impede abusive behaviour on markets, and to maintain the markets' ability to function and to retain their diversity of products.
- fpmi views the draft regulation as requiring the following alterations and clarifications:
 - In contrast to the stipulation applying to shares, the draft does not foresee the disclosure on markets (but merely to official bodies) of net short selling positions held in public bodies-issued debt instruments. This lack would give rise to an asymmetry of the information possessed by holders of short selling positions and of that known to the rest of the market. This would create a problem similar to the one involving holders of net short positions in shares. It would also cause the responsible authorities to accumulate a considerable amount of insider-derived privileged information. These scenarios are leading fpmi to call for the expanding of the requirement to disclose net short positions held in public bodies-issued debt instruments.
 - Required is a more precise determination of the powers foreseen for ESMA, so as to distinguish them from those possessed by other supervisory authorities. The draft reporting obligations for market players repeatedly refer to “relevant authorities”. Requisite to be comprised in the regulation itself or in the norms/indexes forming its underpinnings in hierarchies of legislation is a clear, easy to understand and uncomplicated way of assigning such powers.



- fpmi has a number of criticisms to offer of the requirement to flag short selling orders placed on exchanges. Such a requirement presumes that this kind of transaction is always identifiable as short selling at the time of order placement. Large-sized market players maintaining two or more trading desks and books would, however, be hardly capable of establishing whether or not the transaction in question represents short selling. This applies, for instance, to orders placed for customers. It would not be possible to determine with any level of reliability that this order is in fact a short selling one. The intermediary would have to solely rely on the information supplied by the customer, but would be legally responsible for its correctness. fpmi is thus proposing the limitation of the transparency-enhancing requirements to the reporting by the short seller itself of the net short selling position.
- The undertaking of a range of transactions satisfying a diversity of customer orders is often dependent upon, in daily operations, the entering into a short selling transaction on a short-term basis. These transactions may also serve to safeguard the position of the financial institution. This is then followed in the course of the day by the agreeing of the corresponding loan. The option accorded by the third exception found in Art. 12 of the draft regulation does not take into adequate account the practices prevailing on the German market. fpmi is therefore calling for the adoption of rule enacted in Germany. It authorizes the agreeing upon of a loan in the course of the day in which the short selling was performed (“end of day rule”). This rule has proven very clear and easy to understand and verify.
- The exceptions planned to be made on the prohibition of short selling undertaken by market makers, for customer-based transactions and for dealers authorized to operate on primary markets that are carrying out primary or secondary market operations involving government bonds foresee that these players inform the relevant authorities of their member countries some 30 days prior to commencing these activities. This term is very long. It thus unnecessarily impedes the handling of a customer order. The track record compiled by Germany’s regulation is leading fpmi to call for the submission on a periodic basis (and thus not involving a preset delay of performance) of a report on these instruments, with this to include a detailed account of which of the above roles has been taken for which security. To attain a level playing field, the reporting procedures required by the responsible authorities are to be aligned with each other.