Munich Financial Centre Initiative

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Position Paper

on the occasion of the visit to Brussels on October 14th/15th, 2015

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The EU's capital markets union and how it would impact upon SMEs

Background

- In February 2015, the EU Commission submitted a Green Paper on the creation of a capital markets union. This initiative's objectives are the inducing of economic and employment growth. These goals are to be attained through the improvement of the financing available to companies and thus through the increasing of the investments made in the EU.
- Several of the legislative processes associated with the capital markets union have already been launched. Examples are the ELTIFs regulation and the revision of the Prospectus Directive. The EU Commission's priorities include the creation of an EU-wide framework for high-value securitizations. This also entails the adjustments of the CRR regulation and the Solvency II code of rules. A further move forthcoming from the EU Commission will soon be its concept for the enhancement of the participation by institutional investors in the financing of investments in infrastructure. This push is to include a revamping of Solvency II. The basis for this may well be the second consultation. This was carried by out EIOPA, acting on a commission from the EU Commission. The consultation was on "Infrastructure Investments of Insurers" and took place in summer 2015.
- To put it in a nutshell, the EU Commission's plans strive to induce a closer alignment between Europe's economies and capital markets. Financing secured via capital markets is to gain in importance, as compared to that provided by banks. The EU Commission views this realignment as promising to yield, among other things, an improvement of the conditions under which financing is provided to SMEs (small and medium-sized enterprises).
- The European Parliament has taken a generally positive view of the project of creating a capital markets union. Its Economics and Monetary Affairs Commission did, however, call for a "balanced" approach to corporate financing. This foresees a coexistence of the well-established form of banks-provided financing with the alternatives supplied by capital markets. The European Parliament's resolution on the capital markets union emphasizes the key role played by banks in the supplying of financing to small and medium-sized enterprises. MEPs have also called for the inventorying and assessment of currently-applicable EU financial market regulations. The goal of this is the fostering of the capital markets union.

FPMI's position

<u>Securitization standards and infrastructure financing constitute opportunities</u>

- FPMI basically supports the EU Commission's objectives of improving economic conditions, and of thus encouraging economic and employment growth in Europe. Several of the measures proposed – including the creation of an EU-encompassing framework for securitization and the enlisting of institutional investment in the financing of infrastructural projects - could well help attain these goals.
- The introduction of standards of securitization showing a greater simplicity and transparency can improve the conditions under which financing is secured by small and medium-sized enterprises. This is due to securitization's providing banks with a way of disencumbering their equity, and thus of their being able to channel a greater amount of credit to SMEs.
- The improvement of the conditions under which institutional investors operate could give rise to the creation of safe investments for insurers and pension funds. Such investments in infrastructure could also constitute new drivers of growth of the economies of EU member states. These drivers do not encumber public sector budgets.

No compulsory switching of systems of corporate financing

- Attaining the objective of a capital markets union cannot be achieved solely by facilitating companies' making use of stocks and bonds markets. This is because capital markets-based financing often fails to mesh with the needs of a large number of small-sized companies. This is for a variety of reasons. The volumes of financing that the latter require are too small for capital markets. The costs of processing bonds are also too high for them. A further negative factor: the great extent of disclosures required.
- This means that banks-supplied financing will retain its importance to SMEs upon the forging of the capital markets union. This was emphasized by a poll conducted by DZ-Bank of 1,500 SMEs in Germany.[1] 87.1% of the companies contacted plan on covering their needs for outside financing by taking out bank loans. Financing via capital markets, by way of contrast, is of negligible importance to these companies.
- In Germany and elsewhere, loans from banks constitute a highly-suitable instrument of financing for a wide variety of SMEs. The capital markets union should, for this reason, not be allowed to yield a replacement of a system of corporate financing. It is for this reason that fpmi is joining the European Parliament in calling for a coexistence of banks and capital markets-supplied financing in Europe. The only way to promote economic and employment growth is by improving the general conditions under which financing and investments are made.

FPMI hails the EU Commission's plans to foster capital markets-provided financing, as they facilitate an appropriate coexistence of banks and capital markets-supplied financing (see below). It is with this in mind that the objective of the capital markets union should be the inducing of a playing field attractive to both companies and investors. Below are the positions taken by fpmi so as to bring this about:

- To be avoided when realizing the objective of attaining a capital markets union is an "overtaxing" of companies (with this especially applying to SMEs) seeking capital. The introduction of an "IFRS light" – a universally-applicable set of standards of financial reporting – would add to the costs borne by many SMEs. The introduction would not benefit investors. From investors' points of view, the application of national-level standards of financial reporting (containing the option of employing international standards) absolutely suffices. Arbitrage among financial standards is not discernible.
- Implementing a well-balanced protection of investors is essential for the reaching of a broad base of them. To be taken into account when doing such is the avoidance of a disproportionately great encumbrance of capital-seeking investors. This can be attained by analyzing how the (great variety) of codes of rules ramify upon each other. Such legislation as MiFID II and MAR (Market Abuse Regulation) already ensure a far-reaching and adequate level of investor protection. The costs of a further "deepening" of this protection would be borne by companies. It would thus represent an encumbrance upon a capital markets union.
- An indispensable component of the capital markets union is the creation of an efficient structure of supervision. The primary responsibility should remain with national-level authorities now handling such (subsidiarity principle), in order to take into appropriate account the capital markets' clearly-delimiting and national characteristics (in accordance with the EU's motto of its being a "union of diversity").
- Still needing to be examined is a harmonization of such ancillary legal regulations as corporate, insolvency, and – especially – tax codes. A taxation-caused disadvantaging of equity has to be avoided in order to provide investors with an incentive to furnish the equity constituting an alternative form of financing for companies. The introduction of a financial transactions tax would be in conflict with the objective of increasing the amount of financing stemming from capital markets.
- Taking into account the track records turned in by the banking union and MiFID II, fpmi is calling for – viewing the situation on a general basis – the European Parliament's being entrusted with the reaching of the key political decisions required to achieve the capital markets union. Such decisions are not to be made on Level 2 by such institutions as EBA or ESMA.

[1] https://www.dzbank.de/content/dam/dzbank_de/de/home/produkte_services/Firmenkunden/PDF-Dokumente/publikationen/Mittelstand_im_Mittelpunkt_Herbst_2014.pdf.

Adjusting the regulation of banks to be conducive to the achieving of the objectives of a capital markets union

- FPMI is calling upon the EU Commission to adapt the regulation of banks so as to foster the objectives of the capital markets union. A conflict exists between the EU Commission's promotion of capital market instruments designed to provide financing to corporations and its imposing of regulatory requirements impairing banks' supplying of credit to SMEs. The resolution of this conflict will benefit the business community as a whole. Especially counterproductive would be further regulatory requirements applying to the supplying of loans to SMEs and associated with Basel III. Requiring scrutiny during the consultations on the capital markets union are measures impairing the offering of financing to companies.
- These measures include the pending eradication of a SME correction factor from the EU's equity regulation. Such an eradication would immediately boost the equity required to back loans made to SMEs by no less than 30%. This, in turn, would greatly increase the costs and reduce the supply of such credit.
- A similar effect was yielded by the launching of the structural liquidity rate (Net Stable Funding Ratio). That is associated with a disproportionately great constriction of banks' ability to transform terms. On the international level, the Basel Committee is currently considering the requiring of banks that they assign lump sum amounts to provide for risks of changes in interest. This would also seriously confine banks' transformation of terms, and would thus impair the long-term supply of credit.
- Basel is currently revamping its Standardized Approach to Credit Risk (SACR). This could also negatively ramify upon the provision of credit to SMEs. The implementation of the alterations proposed and being discussed would also increase the capital required, with this applying to corporate credit. The implementation would make it more difficult to secure an adequate amount of means of financing.
- Undermining the objectives informing the capital markets union would also be the harmonization planned for AnaCredit (Analytic Credit Dataset). This would cause the number of reports submitted by the banks in the Eurozone to supervisory authorities to greatly increase. The Bundesbank released the estimate that the number of loans to be reported would increase to 50 million or 60 million solely in Germany upon the lowering of the minimum level of reporting. The burden of the disproportionately large securing of data would primarily be borne by companies seeking loans and by private customers. This would arise from their having to provide a considerably greater amount of data, and from their having to relay this to the banks. Due to this, AnaCredit would constitute yet another bureaucracy-caused obstacle to the provision of loans.

Barriers to an integrated capital market for insurers

- The insurers represented in fpmi view the differences in the variety of legal and tax codes prevailing in Europe as constituting a large-sized barrier to their making investments. This hindrance derives from the insurers' long-term liabilities and the length of term of investment associated with them. These differences are also found in those legal norms supposedly European in scope. Their uniformity has, however, been undermined by the conducting of legislative processes on the national level. This lack of uniformity could, in turn, someday cause the international flow of capital to completely cease. An example of this effect was provided by Hypo Alpe Adria. A further factor to be considered is the under-estimation of the expenditures faced by insurers and ensuing from such activities as the analysis of and legal consulting required by the insolvency codes in force in the respective European countries. A primary objective should be the attainment of an EU-wide, high-level harmonization of legal security. Another goal should be creating conditions stabilizing capital markets. This would strengthen the propensity of institutional investors to also invest on a transnational basis in SMEs.
- The Initiative also contends that the enhancement of consumer protection has given rise to overlappings among Europe's various regulations. Europe's insurers are already required to adhere to the rules imposed by both insurance and banking supervisory authorities. The objective informing the creation of the capital markets union should therefore be increasing the responsibilities borne by the ESAs (European Supervisory Authorities), which would then be called upon to identify Europe-wide problems, and to serve as providers of support for the making of political decisions.

- Case in point: MiFID II solely covers the trading in securities. Several of its rules are, however, also being applied to the distribution of insurance. This, in turn, requires the alteration of the Insurance Mediation Directive (IMD). One result is that brokers and insurers have to undertake precautionary measures ensuring the avoidance of conflicts of interest between themselves and their clients.

Conclusions

- The Initiative basically supports the EU Commission's objective of employing the capital markets union to boost economic and employment growth.
- The introduction of simplified and transparent standards of securitization could improve the conditions of financing and investment prevailing in the EU. The same applies to the plans formulated for the encouraging of institutional investors' participation in infrastructural projects. Both measures have the potential to generate economic and employment growth in the EU's member states.
- The success of the capital markets union is dependent upon the coexistence of the financing provided by banks and by capital markets in Europe. This, in turn, requires the viewing of bank loans as being a pillar of corporate financing in Europe. This view has to be appropriately incorporated into the concepts for the capital markets union. Also requisite is the eradication of regulations-imposed barriers to credit-based financing. To be avoided is, further, the arising of inconsistencies in the new frameworks of governance. Codes of laws and projects applying to capital markets are not to be considered on a stand-alone basis, but, rather, as components interacting with each other and ramifying upon companies and investors. It is only when this has been achieved that the capital markets union will benefit Europe's companies and that it will foster economic and employment growth.
- A further requirement is the introduction of a process of inventorying, development and consultation. It is to be coordinated by the ESAs. To be ascertained is which regulatory measures are still required, and which should be altered due to their overlapping with extant norms. Urgently required is putting an end to the cascading generation of supervisory rules.

Basel III follow-up regulations

Retention of the SME correction factor

Background

- The stipulation applying to loans going to SMEs and whose volume is less than €1.5 million is that the equity backing them is some 24% lower. This, in turn, offsets the across-the-board increase of the equity rates from 8% to 10.5% imposed on the basis of the Basel II's stipulation on loans to SMEs. This relief fails, however, to take into account such other capital buffers as the one for economic conditions. The latter amounts to a further 2.5%. The result of all this is that loans provided to SMEs in accordance with Basel III will feature a progressive rise in capital requirements.
- Stipulated in the equity regulation is that the SMEs' relief will be subject to an assessment by the EU Commission, with this to occur by June 28, 2016 (see Article 501 Paragraph 4 of the Regulation 575-2013). Prior to this, the EBA will compile a report on the risks incurring through and the appropriateness of these loans.
- In contrast to other EU member states, Germany has a relatively large number of small banks and of SMEs profiting from the dedicated relief. The Initiative sees the peril of the Commission's

employing an average when considering the matter on the EU-wide level. This would cause the effect to have a substantially smaller magnitude. This, in turn, would cause the rescinding of the SMEs' relief, so as to satisfy Basel III's stipulations.

- A further factor to be considered stems from a survey conducted by the Bundesbank. It substantiates the viewpoint that considerations of risk also justify the existence of an SME correction factor in Germany. This is due to a portfolio comprised of small-sized loans to SMEs' fostering the diversification of risks. It also enhances the precision of planning for delinquency.

FPMI's position

- The Munich Financial Center Initiative has dedicated itself to achieving a long-term retention of the SME correction factor. This factor has proved its mettle in Germany. It precludes impairments of the provision of financing to SMEs. The factor's retention, in turn, would prevent any negative ramifications upon the economy.

Interest change risks

Background

The Basel Committee issued on June 8, 2015 its consultative document on "Interest rate risk in the banking book". It featured two options: the significant enhancement and Europe-wide standardization of the treatment of risks arising from changes in rates of interest, or, even, an obligatory backing of equity for such. The practice of providing corporate loans at fixed rates of interest is widespread in Germany. The practice would be especially encumbered by this proposal. The addition of another form of a commitment of equity would, further, reduce the volumes of loans that banks can make.

The main responsibility of a bank is to provide the recipients of loans with capital at a variety of terms and volumes. The banks supply capital and manage the associated financial transactions. Another key responsibility of theirs is the transformation of risk. In cases in which banks transform short-term financial funds into long-term investments, they parlay the term spreads, as a rule, into earnings. Increases in the level of interest, by way of contrast, cause the banks to bear the risks of loss. This is because the investments in such cases have to be adapted to be at the new level of interest. Correspondingly, the extant variety of terms play a key role in cases of risks arising from alterations in rates of interest. The effects of such interest rate risks upon the banking book constitute a key component of the monitoring process contained in Pillar II of the Basel rules.

The treatment of interest change risks in the investment book had been repeatedly discussed by the Basel Committee. This was due to the large-scale variation in methods of measuring and managing these risks prevailing in the various EU member countries, and to the greatly differing structures of balance sheets and patterns of behavior found in the industry. These factors causes the stipulations for the treatment of this risk to remain relatively general in nature. Such treatments form part of "internal capital adequacy assessment processes" (ICAAPs). The basis for the monitoring, controlling, identification and measurement of risks ensuing from alterations in rates of interest and found in banking books was established in 2004 by the Basel Committee on Banking Supervision (BCBS).[2] The European Banking Authority (EBA) based a consultation paper on that. The document was published in June 2013. Its objective is to increase the consistency and convergence of methods of calculating supervisory-requiring standardized interest shock.[3] Main components of the

[2] Principles for the management and supervision of interest rate risk (IRR Principles).

[3] EBA Consultation Paper on "Revision of the 'Guidelines on Technical aspects of the management of interest rate risk arising from from non-trading activities in the context of the supervisory review process' from 3 October 2006, under Articles 123, 124 and Annex 5 of Directive 2006/48/EC of the European Parliament and the European Council, published on 27.06.2013.

consultation paper are the planned furnishing of equity for interest change risks and the basic adaptation of methods of calculation of interest change risks.

On November 21, 2014, Genossenschaftsverband Bayern e.V. and Sparkassenverband Bayern published a ramifications study. It showed that the integration of interest risks into Pillar 1 undertaken in accordance with the interest shock model[4] would cause the equity indicator of Bavaria's credit unions to decline from 17.8% to 12.3%.[5] A concomitant of this would be, in turn, that 14% of Bavaria's cooperative banks would experience their equity rate's falling to below 10.5%, with 60% of them experiencing a decline in this rate to under 13%. This would correspondingly reduce the banks' potential to provide credit by up to €47 billion.[6] It would be difficult to offset the possible gaps in equity through the retention of profits. This is due to the forecast declines in earnings, and to expectations that Basel III will cause a further stiffening of requirements.

The rules proposed in the Basel Committee's consultative document on interest change risk, which was published on June 8, 2015, are to be implemented primarily by internationally operating banks on the consolidated level.[7] According to these rules, national-level supervisory bodies are permitted to apply these requirements to other banks. The thrust of the consultative document is also, however, improving the national and international-level comparability of banks. This gives rise to the assumption that the adherence to the rules proposed will be, in the final analysis, demanded of all institutions. This will disproportionately and mainly encumber small banks exclusively operating on the regional scale. This thus comes in conflict with the basic principle of double proportionality.

The proposals submitted on the treatment of interest change risks once more call upon the banks' attainment of a level of capital sufficient to absorb losses potentially arising from risks emanating from alterations in rates of interest. This treatment features the coverage of a generally-applicable risk of changes in interest, with the recognition of such to accord to a single set of specifications. The treatment also comprises the provision of capital backing for risks ensuing from credit spreads. This treatment thus partially encompasses the counter-party default risks already recognized in Pillar 1. A further thrust is the prevention of of capital arbitrage undertaken between banking and trading books, and of arbitrage options among the various portfolios contained in the banking book and subject to differing standards of financial reporting.

Viewed overall, the Basel Committee is striving to achieve a substantial stiffening of rules. To that end, it is providing two options to be used in the measurement of interest change risks containing in banking books.

- The first option foresees the application of a relatively standardized procedure to calculate interest change risks. This would constitute a further component of Pillar 1's minimum capital requirements. Such risks will thus have to be directly backed by regulatory equity.
- The second option specifies significantly more extensive stipulations on the treatment of these risks. This treatment is to form part of 'internal capital adequacy assessment processes' (ICAAPs). These could also lead to supervisory bodies' imposing further requirements to provide capital, with this occurring on a case-by-case basis. In order to exploit the expanded approach taken in Pillar II to the assessment of whether or not there is an adequate amount of capital, the institution would be required to secure authorization from supervisory bodies on a prior basis, as is the practice for other internal models. In such cases, Pillar 1's standardized approach would serve as the “fall-back” to the banks' internal procedures of measurement.

The Basel Committee views the combination of standardized capital requirements and of elements of capital assessment processes as being the driver of the attainment of a greater uniformity, transparency and comparability in this area.

[4] 'Interest shock' denotes the loss in cash value experienced by all interest-bearing transactions in cases in which interest rates rise or fall by 2%.

[5] Position paper of Genossenschaftsverband Bayern e.V. and of Sparkassenverband Bayern, published on November 21, 2014

[6] Position paper of Genossenschaftsverband Bayern e.V. and of Sparkassenverband Bayern, published on November 21, 2014

[7] Interest rate risk in the banking book IRRBB – Consultative Document BCBS 319, published on June 8, 2015.

FPMI's position

- The treatment of interest change risks now being practiced has facilitated the successful managing of banks in Germany. The taking effect of the stipulations contained in the consultive document submitted by the Basel Committee and featuring a revision of the guidelines employed in the management of interest risks would especially encumber the provision of corporate loans at fixed interest rates and terms of capital that is so widespread in Germany. FPMI is therefore rejecting as a general practice the provision of equity for interest change risks, no matter which minimum value is assigned to this.[8] Rules causing the amount of equity backing to further increase should be considered only for banks with high rates of exposure to risks. In such cases – as is the case nowadays – national-level banking supervisors should decided on such on an individual basis.

Transformation of terms - Net Stable Funding Ratio (NSFR)

Background

- NSFR is a liquidity rate. Its objective is to enhance the banking sector's ability to withstand crises by bringing about a well-balanced structure of loans whose terms are greater than a year and whose refinancing is compulsory. The introduction of this liquidity rate could, however, undermine efforts to foster the long-term financing that stabilizes financial systems. This is due to the NSFR's promoting a fixed relationship between the structures of the respective terms borne by banks' assets and liabilities. The deployment of terms of transformation (meaning the transformation of short-term deposits into long-term loans) forming the basis for the provision of long-term financing would be made more difficult.
- The discussion of possible disadvantages resulting from the regulation has caused the market to perceptibly lose interest in supplying long-term loans to SMEs. This feedback has been forthcoming from a large number of SMEs in Bavaria.
- Should this restraint on the part of commercial banks be strengthened by the implementation of the NSFR, it would lead to the risks arising from a long-term financing of an investment's being solely borne by the loan's customers - the companies. This risk would comprise, for example, a change in the rate of interest. In contrast to a bank, a company not forming part of the financial sector has, as a rule, far fewer ways of limiting - or hedging against - risks ensuing from changes in rates of interest or coping with difficulties involving the securing of follow-up financing.

FPMI's position

- The Initiative is calling for a classification by banking supervisory authorities of the NSFR as being an indicator of conditions, and not as a fixed, compulsory and EU-wide minimum value. Also to be taken into account during the in-depth formulation of the NSFR is the specially-strong stability shown by the financing of loans through the use of customer deposits (retail financing). Doing such would enable the setting forth of the culture of long-term corporate financing cultivated in Germany during the last few decades. It was especially the financial crisis that manifested the stabilization emanating from long terms of loan provision.

[8] The equipping of equity to deal with "interest shocks" is governed in Germany by its Solvency Regulation. This is to be proportionate to the equity, as stipulated by § 10 Abs. 2 KWG (Germany's Banking Act). BaFin (Germany's Financial Authority) is entitled – according to § 10 Paragraph 1b Nr. 1, 1. Alt. KWG (Germany's Banking Act) to require a greater amount of equity.

Further development of the standardized approach to credit risk

Background

The rule on the standardized approach immediately ramifies upon the financing secured by SMEs (small and medium-sized enterprises).

- Germany's SMEs generally secure financing from regional banks. This means that an alteration in the rules governing the standardized approach would directly impact upon the availability of loans. The amount of equity that banks have to furnish for corporate loans is conversely related to their room of maneuvering when supplying loans. In the foreseeable future, the ongoing stiffening of the regulations applying to the requisite equity will cause banks to exhaust their capacities to provide credit. This capability should not be impaired by a regulation, especially by one primarily striving to enhance the stability of financial markets.
- During its revamping of the extant body of laws, the Basel Committee has been pursuing the approach of not stiffening the capital requirements as a whole. The Committee has, rather, been striving mainly to make them take risks into better account. The members of fpmi have, however, experienced such a stiffening of capital requirements. This especially applies to corporate financing and to real estate-secured loans – notwithstanding the facts that there has been no identifiable increase in risks in either area. The weighting of risks is being set de facto too high. Simulations have revealed that the capital required by the application of the regulations submitted would increase by 30% in some cases.

FPMI's position

An adjustment of the rules currently under consideration is urgently required to avoid an impairment of the flow of financing to SMEs, an impairment sapping the companies' ability to invest and stemming from supervisory rules. Below is an in-depth look:

<u>No increasing of the capital backing loans provided to companies with low sales</u>

- In the case of the capital backing corporate financing, the current system employs a universal-purpose weighting of 100%. This is set to be replaced by a transparency table that takes into account the companies' revenues and leverages. This would cause small-sized companies - one with low revenues - to be disadvantaged. This is because their risk weighting would be higher, and because the providers of credit to them would correspondingly have to increase the capital backing such loans. This disadvantaging is not justified. The loans forming part of bank portfolios and supplied to small-sized companies are characterized by a high degree of diversification.

- 100% is generally employed as the risk weighting for receivables from companies not forming part of the retailing sector. In the future, a risk weighting of 60% to 300% will have to be recognized. SMEs will not be able to attain a risk weighting of less than 100%. This would constitute a serious disadvantaging of the financing supplied to SMEs.

- FPMI is calling for the retention of the system of averaging the risk weighting of loans not accorded ratings. The failure to reach an agreement in this area would definitely require agreements for loans amounting to less than €1.5 million and going to SMEs' continuing to be backed by today's universally-applicable risk weighting, so as to avoid small-sized companies' being disadvantaged. The spreading of the spectrum of risk weighting depicted from 60% to 300% - and of doing such based on revenues and leveraging – should take effect as of a volume of loans of €1.5 million and above.

Retention of the definition of mass business

- The Basel Committee employs a minimum granularity of 0.2% in the classification of mass business (retail portfolio). This bears a reduced risk weighting of 75%. This minimum disadvantages small-sized banks, as they are not completely able to take advantage of the advantages of having a retail portfolio. By way of an example: a retail portfolio amounting to €200 million is not allowed to comprise a loan coming to more than €400,000 (instead of the ceiling of €1 million). This, in turn, makes loans more expensive for regional and small-sized private banks to issue. This will probably result in restrictions in such issuances.
- The discretionary powers applied to the definition of the criterion of granularity have proven its worth and should for that reason be retained. A concretely-set stipulation – taking the form of the 0.2% criterion currently contained in the Basel III consultation paper – is not appropriate for countries whose banking sectors are comprised of small-sized institutions.

Retention of the capital requirements for real estate-secured loans

- The introduction of a greater, universally-applicable weighting of loan receivables that are secured by commercial or residential real estate is unjustified. The same applies to the increasing of the generally-applicable weighting borne by financing going to developers and real estate. Mortgage-backed loans had been recognized with a risk weighting of 50% (commercial real estate) and 35% (residential real estate) in cases in which a Germany-wide procedure (hard test) had proved that a total delinquency would not cause certain ceilings to be exceeded. The rule submitted foresees (a) the risk weighting to be calibrated to that of the creditor (b) the increasing of the weighting to 75% to 120% (commercial real estate) or to 40% or 50% (residential real estate featuring a typical loan maturity of 60% to 80%). The great retention of value shown by collateral-backed loans and the stability of price shown in Germany make this disadvantaging incomprehensible. The Initiative is calling therefore for a retention of the risk weighting assigned to mortgage-backed loans.

No capital backing for lines of credit

- The standardized approach to credit risks does not require the backing by capital of lines of credit that have not been used and that can be called in at any time. The proposed regulation foresees the lines' getting a risk weighting of 10%. This risk-weighted amount would have to be backed by a minimum provision of 8% of capital.
- A result of this would have to be banks' cutting overdrafts and lines of credit. These are currently used by companies as liquidity and security buffers shielding them from unforeseen fluctuations or from the effects of seasonal businesses. A preponderance of such companies uses such lines and would be affected by this. Banks would experience a great need to augment equity.
- The current rule has to be retained. Revocable and unused credits are not to have to be backed by capital.

No disadvantaging of subsidized loans

- KfW (a Germany-wide public-sector institute) and LfA (operating in Bavaria and also in the public sector) are German banks entrusted with economic development responsibilities. They play an important role in the financing of long-term investments and innovations undertaken and made by SMEs. This financing takes the form of promotional loans relayed via the companies' main banks to the enterprises themselves. KfW and LfA thus maintain large inventories of receivables due from banks. This system is successful and has proven its mettle on the international scale. That is why a number of countries are in the process of setting up similar systems of business promotion.
- Increasing the capital backing receivables due from banks would give rise to a considerable encumbrance and would uproot the very concept of fostering development.

Conclusion

FPMI is calling for a revamping of the draft regulation on the standardized approach to credit risk (SACR). This will enable the banking community to continue to meet its responsibilities. Prime among them is the appropriate provision of credit to SMEs. This constitutes an important driver of the growth achieved by the non-financial community.

Reform of bank structures – banks segregated by activities

Background

- At the end of January, 2014, the EU Commission submitted a proposal on the structure of banks. It is oriented upon the Liikanen suggestions ("Barnier-Rule"). It does, however, have substantially individual features.
- Meeting in Luxembourg in June 2015, the EU's financial ministers (ECOFIN) unanimously agreed in mid-June to the compromise proposed by Latvia, which had the presidency of the European Council at the time ("common position"). The new law's objective is to separate the banks' low-risk deposits-based business from – primarily – their proprietary trading activities.
- In contrast to the European Council, the European Parliament has yet to find a common approach to the draft law. Held at the end of May, a vote by the economics committee responsible for the matter proceeded so controversially that the vote in the plenum was postponed. It is now to take place in autumn.
- Germany has passed a law on the subject. It is thus now ahead of the EU's legislators. Germany's law foresees a system separating banks from certain activities. It is modeled upon that of France. Proprietary trading – meaning those dealings not involving clients (proprietary dealings), algorithms-based trading, and the provision of loan guarantees for hedges and for alternative investment funds are now prohibited – or have to be separated out and assigned to a trading company, in cases in which such exceeds a preset ceiling.
- Germany's restructuring act took effect on January 1, 2015. As of July 1, 2015, banks exceeding the ceilings foreseen are required to determine within six months which "prohibited" businesses they are pursuing, and to end these within the subsequent six months, or to assign them to a financial trading institute. The final promulgation of the EU's rules is not expected prior to the end of 2016. This means that they won't be applied until 2017.

FPMI's position

- The Initiative approves of the current ECOFIN proposal. As a basic rule, all measures increasing the resiliency of the banking system and lowering the risks of a bail-out are to be welcomed.
- ECOFIN's "common position" constitutes a strong foundation for the ensuring that the various legal codes do not diverge too substantially from each other.
- An important "to do" is also to achieve the synchronization between the EU's regulation and the national-level acts on the separation of banks' operations.
- The lack of agreement in the European Parliament has given rise to a limbo leading a sense of legal insecurity. A rapid reaching of an agreement is urgently needed.

The Initiative's demands: a detailed look

- The main thrust of the Liikanen Reports was an attainment of the internalization of external costs. This was because the trading transactions undertaken in universal banks are supposedly not valuated at their full costs. A segregation of such would allegedly put an end to this. To be noted, however, in this regard is that it was precisely to internalize these external costs that equity requirements were stiffened and the supervision of banks was strengthened (case-in-point: Basel III). This objective will also be achieved by the introduction of restructuring and winding up plans for banks. This fact has been confirmed by a study issued by PWC.[9]
- Germany's universal banking system has functioned well. It has proven its mettle, with this especially applying to times of crisis. Nearly 80% of the financing secured by the country's business community takes the form of credit. The community is thus reliant on there being

[9] http://www.pwc.com/gx/en/banking-capital-markets/pdf/pwc-study-impact-of-bank-structural-reform.pdf.

strong universal banks ("one-stop sources of finance"). The importance of the universal bank model has been repeatedly emphasized, with this including the commentaries issued by the ECB, the progress report from the Italian presidency of the European Council, and the Hökmark Report. Universal banks have to continue to be capable of concluding with their clients agreements enabling the latter to use hedging instruments meeting their needs. These hedges protect clients' transactions against changes in interest rates and rates of exchange. Trading transactions encompassing clients should be not be affected by that. Banks are to remain "one-stop" sources of such instruments.

- The common position expressed in the ECOFIN proposal forms a strong foundation for the getting a grip on the "too big to fail" problem. The important thing is to now achieve the synchronization between the EU's law and, for instance, Germany's act on bank segregation. This will ensure that the various legal codes in the EU do not too sharply diverge from each other.
- The draft act on bank segregation assigns financial institutions into two different classes of risk. This is done by employing a simple-minded ceiling (this is constituted by the sum of trading activities undertaken during the last three years' having exceeded €100 billion or not). A glance at the inceptions of the financial market crisis reveals, however, that this classification is far too primitive. This factor has resulted in the previously-enacted measures (contained in BRRD, Basel III) deploying methods that are significantly more differentiated. More much suitable would be a risk-based approach.
- To be noted, however, is that ECOFIN's current draft is precisely not to apply to institutions whose "total eligible deposits" amount to less than 3% of their "total assets", or to whose "total eligible retail deposits" are less than €35 billion. This would exclude US investment banks from this scope of application. Also excluded would be special-purpose large-size banks with small amounts of deposits and active in the EU's area. These exclusions would lead to distortions of competition. These are to be avoided.

Deposit security in Europe

Background

- Jean-Claude Junker, the president of the European Commission, was joined in June 2015 by the heads of the EU's other institutions in submitting a plan for the "Strengthening of Europe's Economic and Monetary Union". The "Five Presidents' Report" foresees the creation of a European system of protection of deposits at banks.
- This entails the joining of national-level measures of securing, and consigning them in a common European system going by the name of the "European Deposit Insurance Scheme" – "EDIS" for short. The first step towards achieving such is planned to be the setting up of a reinsurance system among these national-level bodies. An agreement on such is to be reached by June 2017.

FPMI's position

- The plans for EDIS contain substantial risks. A communitization of deposit insurance would enhance the tendency towards inducing a transfer union among banks in Europe. This would be due to stable and well-performing banking systems' having to be liable for instable systems, and to have to do so without having any influence upon the latter's propensity for engaging in risks. In the case of Germany, this would mean that money set aside in this country to ensure savers' security would be up for grabs by banks in crises, should such a mega-breakdown occur. Such an arrangement would foster overly risky behavior ("moral hazard"). Any incentive to adequately stock national-level security funds would be removed. The EU's member states could, instead, rely upon emergency assistance.

- A further problem is that a communitization of liability-related risks would promote – in a key point – the spreading of instability throughout Europe. The firewalls protecting security funds would be eliminated. This would cause the problems being experienced by weakened banking systems to be stripped of the ability to be effectively treated on a stand-alone basis. These problems, rather, could infect – much more expeditiously – other systems of deposit security. Germany's citizens have built up over the generations their trust in the country's system of deposit insurance. This would suffer under the new system.
- With this in mind, fpmi rejects the communitization contained in the European system of deposit insurance. This rejection extends to the "reinsurance solution", which is designed to be a precursor of the system. A transfer union cannot be allowed to come into being in Europe. The funds gathered over many years in Germany's banking system's insurance mechanisms for purposes of securing customer deposits are not to be permitted to be employed to satisfy claims for liability arising from banks whose business models differ strongly from those used in Germany, and which often feature risky practices.
- The setting up of Europe's banking union has been completed. The new structure has three pillars: a single, encompassing system of supervision, a uniform method of winding up banks, and a harmonized securing of deposits. The revamping of the EU's Deposit Insurance Directive was undertaken by the EU's legislators to enable them to pursue the path of harmonization of national-level systems of deposit insurance. The EU-wide specifications are currently being implemented in the member states. This is causing the further and corresponding development of such systems. Each member state is now charged with the development and extension of its deposit insurance system. A recommencing of the discussion on a communitization of extant deposit insurance systems is also for this reason counterproductive. What should actually be pursued is, rather, the further strengthening of the sense of being responsible for one's own fate on the part of the EU's member states, their banks and their deposit insurance systems.

Ramifications of digitalization

Background

- Digitalization-caused trends are rapidly and dynamically changing the business world. These trends are giving rise to new challenges. These are also being faced by the insurance and banking industries.
- Chains of value added are being increasingly digitalized. Customer-centered electronic services are becoming more and more important. Innovative 'big data'-based technologies are enabling the development and offering of new products.
- The pressure ensuing from these changes fosters innovations on the part of companies. It forces them to adjust to the new situations prevailing on markets. This adjustment takes the form of altering the conditions shaping digital business models.
- The EU's institutions have dedicated themselves to pursuing this topic. They will expedite the creation of state-of-technology infrastructure.

Ramifications: how the insurance industry views them

Conditions of competition:

A level playing field – in which all players compete under the same conditions – is a precondition for the achievement of the most expeditious adjustment to the digital era possible. Much of the capacities of insurers' IT departments now go to satisfy regulations. This expenditure of time and money confines insurers, and impairs their ability to deploy IT in other areas.

Of decisive importance is a preclusion of a disadvantaging of insurers. This applies to such world-spanning topics as the laws and regulations forming the conditions under which this digitalization takes place. Especially prone to this disadvantaging are globally-operating insurance groups and insurers that partially outsource their operations, and those that are required to separate and consign their activities – in such areas as life, indemnification and casualty insurance – to dedicated companies. This disadvantaging is vis-à-vis other globally-operating companies, and other players on markets, be they subject to regulation or not. What is required is ensuring that all players operate according to a single set of conditions.

To bring this about, the following principles have to inform the formulation of regulations:

- Each regulation should constitute the highest possible standard of harmonization in Europe – or, better, in the entire world. Achieving this will exclude a proactive circumvention of the rules, or their avoidance through the outsourcing of activities to areas featuring less strict standards.
- Each regulatory measure should not be confined to an individual sector or offering party. Case-in-point: high-tech companies that offer services in the financial area. Such companies have to adhere to the rules observed by providers of financial services. This implies that companies subject to financial supervision are not to be subject to stricter rules. In concrete terms: to be precluded is a regulations-ensuing arbitrage. This would involve digitalization and pertain to companies entering financial markets and experiencing conditions that are more favorable than those experienced by companies subject to supervision.
- The breakneck speed at which technologies are developing constitutes a driver of the creation of unfair conditions of competition. What is required in this regard is precluding the ensuing of monopolies giving rise to anti-trust concerns. Such structures could arise, to provide an example, from such large-scale collectors of data as Facebook's or Google's unilaterally exploiting their positions on markets.
- Consolidated groups are to be considered a single company. This entails their being allowed to transfer data – also on a transnational basis – within their groups, and to do such without limitations.

<u>Data protection:</u>

The original insurance business was predicated upon advising customers. This has partially been extended to include – or has even been replaced – by the simple interactions taking place between the companies and their customers. This is possible only in cases in which the legal security accorded to contracts concluded on-line has been improved.

The secure processing of data - including of that pertaining to customer health - in primarily the life, health, casualty and liability insurance sectors gives rise to huge challenges. These are faced by corporate distribution networks and digital infrastructure. The insurance companies are highly interested in maintaining a high level of data protection. This data protection should not be allowed to be a hindrance to business. Also urgently needed is the compilation and maintenance of a set of standards that apply throughout Europe and the world, and that intelligently solve these problems. This compilation should incorporate the following principle:

- Viewed generally, the attainment of a high degree of data protection is a requisite. It is for this reason that we support the inculcation of a Europe-wide understanding of "protection of property" and "ethics" in this area. We are calling for such technology-supported options as "choice and consent" – meaning that the customer gets to decide which data that she or he wishes to disclose – and to which extent.
- It is precisely in the case of insurers that the utilization and processing of data all along the chain of value added makes sense. This starts with the development of new products and extends to the calculation of insurance premiums and to the rapid processing of cases of damage, and to the detection of insurance fraud. It is for this reason that the processing of data has to be unlimitedly possible – under the precondition of pseudonymization (meaning the complete maintenance of the anonymity of the respective person vis-à-vis the unit processing the data, with these encompassing cases of outsourcing and offshoring). This is not to pertain to the original gatherer of the data (the insurance company). The data is to be capable of being

traced by them back to the customer involved. Complete anonymization would go too far. It is counterproductive in a world whose great efficiency comes from the division of labor.

- Each case of loss of data should not give rise to disclosure obligations. As is the case in the USA, this should be the case only when especially sensitive data is involved.
- Customers' portability of data and access rights should be limited to basic data (for instance: information on the categories of data that the company has saved from customer entries). Access to and portability of all data would yield each customer's being able to demand the releasing of copies of all documents – including E-mails - in which her or his name is noted, with this entailing the blacking out of the others.

Other topics:

In addition to these subjects of fundamental importance, the digital agenda also has to include the dealing with a large number of other topics. For instance: how monopolistic structures – ensuing from the gathering of data by Facebook and Google – can be precluded. Especially requisite is the ensuring of utilization of the data gathered in a way according to anti-trust regulations (by way of an example: the automobile insurance's eCall system of emergency notification).

Insurers' customers are reliant upon the ensuring of their digital business transactions' confidentiality, conclusivity, security and authenticity. This state of affairs has to be maintained by all players on markets in Europe and in the world, with this especially applying to companies new to the insurance market. Digitalization yields the great opportunity of making products simpler and easier to understand. Consumer protection has to orient itself to these facts of life.

Developments on the IT market will no doubt cause a revamping of insurance services. This will feature new products, new kinds of structures of distribution, and, perhaps, new risks for consumers. Notwithstanding this, the basic model employed by insurers – of using collective-based offsetting – cannot be blunted by the use of Big Data.

A further thrust has to be pursuing the ascertainment and fostering of the ability to get coverage for IT-caused risks.

Ramifications – the banking industry's view

Conditions of competition

- Policy-makers and financial supervisors have – correctly so – devoted themselves to achieving a strict regulation of the banking business. This especially applies to the loan and deposit areas and to advising on investments. This dedication has yield a substantial improvement in the industry's ability to manage risks. Disclosure requirements have been extended. Supervisors have been equipped with far-reaching rights of intervention. Both moves have enhanced the stability of financial markets as a whole. Several of the stipulations in these areas would seem to be overly ambitious. This is due to the limitation of risks arising from the approach to business taken by savings, cooperative and other - locally-operating - banks.
- Policy-makers and authorities have yet to complete the formulation of a widely-applicable position on fintechs (companies providing financial technologies). Those bodies charged with regulating and supervising banks take a conservative approach to such companies. This is due to their concern for the stability of financial markets. Politicians and fair trading authorities, by way of contrast, emphasize the innovative and competition-fostering components of these companies' activities.
- The banking industry sees the optimizing of customer utilization and the incorporation of innovations into financial services as being linked to the ensuring of the stability of financial markets, of a fair sharing of risks, of consumer protection and of product security. Each savings and other bank has to closely monitor this linkage and the tension of operation that it causes. This linkage gives rise to opportunities and risks. These are faced by all market players (banks, fintechs and their respective customers). Each of these has to evaluate and decide upon these on a stand-alone and independent basis. Politicians, supervisory bodes, anti-trust authorities and players on markets have to develop a commonly-shared understanding of this process, so

as to serve the interests of customers and these players. A longstanding role model for such is constituted by the core areas of banking supervision.

- A large number of business models used by fintech companies are based upon the utilization of the technical infrastructure made available by savings and other banks to the customers. The former thus profit from a platform meeting the highest and strictest standards of security and of supervision, a platform whose operation is thus complicated and cost-intensive. Banks are thus prime enablers of a number of fintech business models.

The banking industry: its expectations

- Viewing the matter as a whole, each player on the market – both new and established providers – is to be put into the position of having the same ability to exploit the potential of opportunities. This means that banks, too, are not to be per se subject to stricter regulation or supervision than other players on the markets. Nor is this to occur without taking into account the business involved. The following general rule is to be observed. The same rules are to apply to the same business ("level playing field"). This is the only way that opportunities and risks can be equally and equitably shared. A failure to achieve this would impede the incorporation of innovations on markets, and would cause the favoring of business models designed to exploit disruptions.

- The functionality of economies has to be assured. This also applies to the protection of consumers. Attaining these objectives requires, in turn, the maintenance by politicians and supervisory bodies of the core areas of the banking business and of the system of supervision associated with it. Financial technologies companies are also to be required to adhere to this, and to have their operations approved by supervisory authorities, in cases in which their businesses require such.

- All players on markets are to be expected to adhere to generally-applicable laws (such as those on consumer and data protection). Also to be expected is the effective enforcement of the legal codes applying to these matters and these players.

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