UNIFE position on the Alignment of EU rules on capital requirements to international standards

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Summary

On 27 October 2021, the European Commission adopted a Proposal for a Regulation to amend *Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor*[1], the so-called the **Capital Requirements Regulation** or CRR. This file is part of a broader package which aims to implement the final elements of the internationally agreed prudential standards for credit institutions developed by the Basel Committee on Banking Supervision, also known as the "Basel III framework".

The EU co-legislators are set to start negotiations on this file in 2022. In this sense, UNIFE, the European Association of the Rail Supply Industry, shares its views and concerns on some concrete aspects of the new proposed Regulation, namely on the **Credit Conversion Factor (CCF) for Technical Guarantees and Effective Maturity recognition for Trade Finance.** UNIFE agrees with a wide range of stakeholders including the the International Chamber of Commerce (ICC) that:

- **the proposed increase of the CCF from 20% to 50% is overly punitive; and**
- **applying an average 2.5Y for the effective maturity recognition for Trade Finance will create a significant price increase for European corporates and SMEs**[2].

Therefore, the European rail supply industry is concerned that these two provisions will have large **negative consequences for the provision of cost-effective trade finance to the real economy**. Given that international trade will be a vital form of relief for many companies – particularly SMEs – in the wake of the Covid-19 pandemic but also in the uncertainty and challenges derived from the war in Ukraine, we call on EU policymakers to carefully consider the proposed amendments, so trade finance assets are not regulated in a penalizing manner under the final Capital Requirements Regulation.

The potential impact of the changes contemplated by the draft regulation could have **far-reaching consequences for the competitiveness of EU-based companies** trading (or seeking to trade) internationally and, moreover, for the achievement of the ambitious targets set out in the European Green Deal.

About UNIFE

Operating in Brussels since 1992, UNIFE represents European train builders and rail suppliers. Our association advocates on behalf of more than 100 of Europe's leading rail supply companies, from SMEs – which represents a third of our members – to major industrial champions, active in the design, manufacture, maintenance and refurbishment of rail transport systems, sub-systems and related equipment.

With the 400 000 jobs they provide, their €47 billion of combined annual sales and the environmental excellence of the products they manufacture and sell all over the world, European train-builders and rail equipment suppliers have been a key contributor to the competitiveness and sustainability of Europe's industry. Our members account for **84% of the European, and 46% of the global, market for rail equipment and services**.

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0664
[2] https://www.icc.se/wp-content/uploads/2022/01/20211223_icc_crr_position_paper.pdf

Increase in the CCF for “Technical Guarantees” from 20% to 50% [CRR Art. 111 and Annex 1]

Technical Guarantees are a traditional trade finance product widely used in the real economy such as the supply of rolling stock, signalling systems and rail infrastructure and the long-term maintenance thereof. For this reason, the provision of Technical Guarantees cannot be compared to trade-unrelated financial activities such as direct credit substitutes and other off-balance sheet exposures which are linked to non-financial stand-alone derivatives trading.

The majority of contracts that rail suppliers and manufacturers execute imply the issuance of these products. According to the World Trade Organization, **over 80% of international trade relies on a form of trade finance. By requesting Technical Guarantees,** clients secure their investments with contractual terms and conditions, including penalties to the contractor, applying in case of non-performance, delays on execution, termination of the commercial contract, contractor bankruptcy, and ensure the proper execution of the contract.

For the European rail supply-industry the provision of Technical Guarantees such as bid bonds, performance bonds, advance payment bonds and warranty bonds are typically a requirement for both private and public-sector tenders and consequently embedded in the respective supply and services contracts worldwide.

The historical risk level on guarantees is very low: according to the 2021 ICC Trade Register, the obligor weighted default rate of performance guarantees is below of 0.5 % and even 0.25% over the last few years. In addition, it is worth pointing out that worldwide practices are not similar: in some large third countries, projects are not secured with guarantees but with instruments issued by insurance companies, which will neither be impacted by this limitation of capacity nor this price increase.

In this sense, it is overambitious to align all the financial instruments when national standards and practices are not the same and when the impact of the CCF increase will penalize specifically the European financial institutions, limiting their capacity to support large European contracts. According to the ICC, the proposed change of 20% to 50% of the CCF will increase the cost of Technical Guarantees by up to 150%, with heavy impacts on corporates but especially on SMEs. Therefore, financial institutions will be reluctant or even unable to provide the bonding capacity necessary to enable sustainable mobility projects. The increase of the CCF will significantly increase the Risk Weighted Assets (RWA) for the product and thus, lead to a reduction in guarantee capacity.

Consequently, a restricted access to guarantees caused by an increase in the CCF will negatively affect the capacity to invest in sustainable green rail infrastructure projects, which are essential to accomplish, for example, the targets set at the EU Green Deal. Considering the global dimension, the immediate cost increase from change in CCF via core EU banks will be passed on to the EU industry and there will be an increased demand for trade finance instruments from banks not implementing the CCF increase. Thus, a cost increase and / or limitations to access capacity by European suppliers.

Given the increased need to invest in green sustainable projects and the large public funding allocated to them, the demand for Technical Guarantees will also increase in the coming years. Since 2008, the volume of guarantees imposed in large infrastructure projects has steadily increased: in absolute terms as well as in relative terms compared to the contract sizes. In addition, some clients can request increasingly stringent restrictions on financial institutions such as minimum rating for the issuer or localisation in the client’s country. All of this reduces the number of financial institutions able to allocate capacity for these large projects, concentrates the capacity to issue withing a group of banks or insurance companies and reduces automatically companies’ capacity to negotiate the cost of these instruments.

In the normal course of business, the cost of technical guarantees is included in the project price. Therefore, to maintain their competitiveness, companies will attempt to increase their prices or margins will be further under pressure. The lower the credit rating of the company is, the greater the financial impact will be. Small companies, that are usually not rated by an external rating agency, will be even more effected by the change in CCF.

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European suppliers would face further distortions to a level competitive playing field putting at risk European technology and jobs. Additionally, an uneven level playing field for European banks could be created since other financial institutions will be issuing Technical Guarantees without being subject to the same capital requirements which will become mandatory at EU level.

In this sense, UNIFE calls on the EU co-legislators to amend the proposed classification of Off- Balance Sheet Items. Thus, Technical Guarantees should be included in the bucket 4 corresponding to medium low risk and hence maintaining the 20% CCF.

Effective Maturity vs 2,5 years fixed [CRR Art. 162]

As recognized by the ICC Trade Register Report, Trade Finance deals have very short maturities i.e.: life cycle services, import/export loans and supply chain programmes have an average maturity below 130 days. It is important to note that the previous Capital Requirement Regulation had already recognized the short term and self-liquidating nature of Trade Finance. Thus, allowing financial institutions to measure and apply a specific maturity when calculating capital requirements.

Even if the proposed revision foresees the possibility to apply the effective maturity (instead of 2.5 years fixed for all transactions) for short-term self-liquidating trade finance transactions, as well as issued or confirmed Letters of Credit, it is not fully clear whether this is applicable when the Foundation-IRB (internal rating based) method is used. The new element in the proposed text is that the F-IRB method will have to be applied to Large Corporates (>EUR 500m turnover) which are the largest user of trade instruments.

In this sense, UNIFE calls on the EU co-legislators to clarify the applicability of F-IRB method and maintain the permission to break the 1-year floor due to the fact that the short-term and self-liquidating nature of Trade Finance has been already recognized in the previous CRR, which allows for Trade Finance products to be exempted from the one year maturity.

Conclusion

Analysis from the European Commission shows that the EU Rail Supply Industry is a global leader on exports on rail infrastructure and rolling stock and that its value has grown more than four times since 2000 to reach € 4.8 billion in 2017. China and the USA were in second and third positions, respectively, each of them with less than half of EU exports3. Maintaining this leadership will be key to assure the competitiveness of the industry which clearly contributes to EU's strategic autonomy.

In times when the decarbonisation of the economy is more urgent than ever before, the European rail supply industry can offer sustainable and resilient alternatives to accomplish the decarbonisation of the transport sector. Cutting greenhouse gas emissions from the transport sector by 90% by 2050, compared with 1990 levels is a crucial element to achieve climate-neutrality. This endeavour will require further boosting investments in rail mobility products and services to accelerate a modal shift to rail as the backbone of sustainable mobility worldwide. The issues explained above will reduce the competitiveness of our industry and companies, furthermore on public procurement markets when the award of the contract does not follow the Most Economically Advantageous Tender principle but rather is on the “lower price”.

With the planned Basel III changes, banks will be forced to allocate high capital to these products. This is likely to force banks to reduce their support to the industry at a time when it is looking to expand in Europe and worldwide with a political momentum and a wide range of public investment programs supporting green and sustainable mobility. Consequently, European suppliers would face further distortions to a level competitive playing field putting at risk European technology and jobs.

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