Rolls-Royce

Rolls-Royce plc

EU transparency register number: 58290033126-06

Comments in response to

Consultation by the High-Level Expert Group on reforming the structure of the EU banking sector.

Rolls-Royce[i] welcomes the High-level Expert Group consultation on possible reforms to the structure of the EU banking sector.

Since 2009 Rolls-Royce has been actively involved in trying to ensure new financial regulation being developed in the wake of the crisis meets the needs of non-financial companies and does not have unintended consequences for the real economy. Our initial focus has been on the preservation of the OTC derivatives market which non-financial companies use for risk management purposes. However our focus has broadened to the general cost and access of credit, rising costs associated with successive regulation and the potential inefficiency associated with their compound effect. This is becoming particularly acute for SMEs in our and other large companies' supply chains. Together with the European Association of Corporate Treasurers (EACT) and other European non-financial companies we formed a cross-industry coalition in 2010 to ensure that non-financial companies' interests are better represented.

Regulatory proposals such as EMIR, CRD IV & MiFID II remain a serious concern. These proposals risk undermining the uncollateralised OTC derivatives market that non-financial companies rely on to hedge their commercial risks, either through mandatory centralised clearing, punitive credit charges for non-collateralised transactions or through changes in the structure of the markets. These regulatory developments could result in non-financial companies having to post margin (cash collateral) which will tie up cash that could otherwise be deployed for investment in the real economy, supporting research, development and growth in the EU.

Structural reform of the banking sector cannot be considered in isolation from the above and other developing financial market regulation. Compound regulation risks adding cost and inefficiency into the financial system. The cumulative impact of all regulation needs to be assessed in detail through consultation with all stakeholders to ensure that any costs are outweighed by additional benefits. Non-financial companies want an efficient system which balances stability with growth whilst avoiding prohibitive expense that reduces global competitiveness. The current aggressive implementation timetables increase the risk of unintended consequences and create a danger that risk transfers out of the financial regulatory universe into the real economy where its effects may be more opaque.

We hope this is helpful context for our more detailed response to your consultation. This document is on record and may be freely quoted or reproduced with acknowledgement.

Q1 What are the main banking services and products that you seek from your bank?

As a global company Rolls-Royce utilises a wide range of products and services provided by approximately 65 global banking counterparties:

- Bank loans – revolving credit facilities and overdrafts
- Deposits – short-term cash deposits and money market fund investments
- OTC derivatives - foreign exchange, commodity prices, interest rates, inflation, credit
- Trade finance - letters of credit, promissory notes, bonding, factoring
- Asset-based financing - leasing of goods, both as lessor & lessee
- Cash management tools - payment services, cash pooling etc
- Custodian services
- Tradable securities (gilts, treasuries, bonds, commercial paper, repos, reverse repos, certificates of deposit etc)
- Advisory services, e.g. mergers and acquisition advice, bond issuance etc

The following two questions are answered together:

Q2 What impact do the current and ongoing financial regulatory reforms have on the availability and cost of financing and other customer services of banks?

Q3 Do you observe and expect a shift away from bank finance to other sources of finance more generally in the EU? What are the main constraints to such a shift?

Availability and Cost of Financing

Non-financial companies need readily available access to credit and liquidity at an affordable cost in order to fund investment for future growth. Whilst most large investment grade companies currently have access to funding at affordable pricing, their supply chains and SMEs are struggling.

Implementation of Basel III guidelines through CRD IV is impacting the availability and cost of funds even before the regulation is finalised and implemented as banks form a view on the expected outcome and plan their business accordingly. G20 pressure has the effect that some countries are fast tracking the implementation of increased capital requirements rather than taking a more phased approach. This combined with significantly increased bank funding costs is exacerbating the problem, resulting in lower levels of lending to non-financial companies, at a higher price. The problem is particularly acute for SMEs.

If financial market regulation and other factors reduces the availability of bank funding or makes it more expensive, non-financial companies will naturally look to other sources of finance such as bond markets, private placements, commercial paper markets etc. However, many of these alternative sources of funding are only available for larger companies and not SMEs. In addition SMEs may not have the resource and expertise to attempt to raise funds via these alternative sources. Whilst it might be possible to develop other sources of finance for SMEs to access, this will take time. The economy needs investment now.

Large companies are able to access bond markets globally, often raising funds in a foreign country (e.g. the USA) and converting them back into their home currency using a cross-currency swap to hedge out the interest rate and foreign exchange risk. The benefits of this are twofold; the company is not restricted to the potentially limited investor base of their home country, and there is competition for investment as companies can choose the cheapest market from which to raise funds. The interaction of different pieces of financial regulation therefore becomes important. For example, under CRD IV, increased capital charges for long-dated, uncollateralised cross-currency swaps increase by up to 5 times

depending on maturity and the credit rating of the counterparties involved. This puts a constraint on a company's ability to raise funds from global bond markets as the increased cost of the required hedge makes the overall all-in borrowing rate less attractive. The two benefits of global bond markets highlighted are therefore reduced.

As previously noted, generally SMEs do not have access to global bond markets and are much more reliant on funding from local banks. Rolls-Royce, like many other large companies, has a large number of SMEs in our supply chain that we rely on for timely delivery of our products. In fact 7000 of our 8000 suppliers are deemed to be SMEs. A key concern is that whilst Rolls-Royce may have access to funding, our suppliers do not. The European Central Bank "Survey on the access to finance of small and medium-sized enterprises (SMEs) in the euro area" dated 27th April 2012 highlighted that euro area SMEs external financing needs increased between October 2011 and March 2012. At the same time, access to bank loans continued to deteriorate, as firms reported a worsening in the availability of bank loans (20%, up from 14% in the previous survey).

Rolls-Royce do not see it as our natural role to be an intermediary sitting between banks and our supply chain. However it has become necessary to get involved due to a tightening credit environment experienced by our suppliers. In 2009 Rolls-Royce put in place a Supply Chain Finance scheme which allows suppliers to discount invoices and receive early payment for the goods they have delivered. Throughput on the scheme has doubled from $300m in 2010 to over $600m in 2011 indicating that our suppliers need this financial support.

There has been some debate as to whether retail investors could meet some of the funding requirements of non-financial companies. Whilst we agree that some sophisticated retail investors may be able to analyse the risks they are taking, it is questionable whether the market would ever be large enough to replace a significant amount of bank lending to non-financials. Banks should have a role in credit intermediation between depositors and borrowers as they should be better placed to do the credit analysis than small individual retail investors. The direct credit risk naturally sits better with the banks.

It is difficult for a non-financial company to accurately identify the increase in cost of funding that can be attributed to financial regulatory reform from other causes such as bank funding costs or changing credit spreads. However a Standard and Poor's paper[1] estimates that funding costs could increase in aggregate by between €30bn and €50bn per annum for European corporate borrowers by 2018, representing an increase of between 10% and 20% over current interest costs depending on banks' return on equity targets.

Availability and cost of other bank services - OTC Derivatives

Our main concern with current and future financial regulatory development is that it must enable large companies and SMEs to continue with their established risk management practices, and that key financial products such as uncollateralised OTC derivatives must be available at a reasonable cost.

Rolls-Royce and many other companies use OTC derivatives to hedge against risks resulting from their operations, e.g. foreign exchange rates, interest rates, commodity prices etc. As an example, Rolls-Royce has a very long-term business model with contracted revenue streams out to ten years and beyond. A large proportion of these contracts are denominated in US$, but we have a largely GBP cost base. The company therefore has a large and long-term exposure to the GBP vs US$ exchange rate.

In order to protect the GBP and EUR value of US$ income the company enters into bespoke OTC derivative contracts where it will sell US$ at an agreed exchange rate up to ten years in the future. The

[1] Why Basel III and Solvency II will hurt borrowing in Europe more than in the US, September 27 2011

risk of any movement in the exchange rate is transferred to a bank who acts as an intermediary to lay off this position with another party who has the opposite exposure.

The bespoke nature of OTC derivatives allows the company to manage the exact risks that it has from its underlying commercial contracts, and avoid being left with any residual risk that would arise from being forced into using a standardised product that does not meet our requirements. Reducing financial risk using OTC derivatives allows non-financial companies to focus on the development and growth of their business, reduced volatility in cash flows and profits allows companies to plan effectively and be confident in investing for the future.

In principle, non-financial companies have secured an exemption from mandatory clearing and collateralisation of OTC derivatives if they are being used for hedging purposes[2]. We now rely on ESMA (the European Securities and Markets Authority) to turn this principled wording into more detailed legislation. Any further regulatory developments should ensure that uncollateralised OTC derivatives market is preserved and that OTC derivatives are available at a reasonable cost. Any regulation must also recognise that different stakeholders (e.g. retail vs wholesale) can manage different levels of risk.

Q4 What are your views with respect to structural reform of banking in general and in particular with respect to the structural reform proposals to date (e.g. US Volcker Rule, UK ICB proposal)?

Structural banking reform needs to be considered alongside all other financial market regulation that is being implemented post crisis. For example:

- Basel III and CRD IV already address the amount and quality of capital that banks are required to hold and also defines additional liquidity and funding measures.
- EMIR forces banks to centrally clear standardised OTC derivatives and collateralise all non-standard derivatives.
- MIFID impacts the structure of markets and how financial instruments are traded, including pre and post trade transparency and position limits.
- Deposit insurance schemes are already in place protecting the first EUR 100k of any retail deposit.

The key question is what the aim of structural banking reform is in terms of the additional protection being targeted and at what cost this can be achieved? Is ring fencing or a ban on proprietary trading required in addition to the above measures and what is the cost / benefit trade off? The cost of compound regulation will be borne by the end customer, either retail or wholesale.

UK ICB proposal – Ring Fencing

The UK ICB proposal being considered addresses the moral hazard of 'too big to fail' by ring-fencing retails deposits and loans from other banking activity and separately capitalising the ring-fenced and non-ring-fenced banks. If banks are to be ring fenced then there needs to be a distinction between wholesale and retail customers and the level of protection given should differ to reflect the level of sophistication of the parties involved. If not, excessive protection for wholesale customers would be hugely costly and burdensome. Broadly speaking wholesale customers should be able to choose who they deal with and how.

[2] Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on OTC derivatives, central counterparties and trade repositories COM(2010) 484 final.

Ring fencing certain activities may mean that banks lose the portfolio effect of netting between loans, deposits, derivative exposures etc, potentially increasing cost and inefficiency in the system.

Consideration needs to be given to other areas of moral hazard such as central counterparties (CCPs) where significant concentration risk is being created. If CCPs are to compete with each other this raises a serious question as to what they will compete on. If it is price it risks creating a race to the bottom that could ultimately trigger another 'too big to fail' dilemma in Europe.

US Volcker Rule – Ban on Proprietary Trading

The definition of what constitutes proprietary trading is obviously critical. Non-financial companies need banks to be able to provide liquidity and market making activity in OTC derivatives, bonds and other markets, facilitate the execution of large trades, provide underwriting services etc.

Q5 How do you value the ability to engage in "one-stop-shopping" for all your banking needs?

Rolls-Royce currently deals with around 65 banks. We are agnostic between specialised and supermarket banks, provided that they meet our requirements in terms of creditworthiness, capability and pricing.

Structural banking reform should not result in the loss of financial products that are integral to the way non-financial companies manage their businesses. Key financial products such as uncollateralised OTC derivatives must be available at a reasonable cost.

Further Information

Rolls-Royce is available for further comment should you wish to discuss any of the issues raised in the discussion paper in more detail. Please contact: James Harvey (Assistant Treasurer) james.harvey@rolls-royce.com or Charlotte Andsager (Vice President - EU Affairs) charlotte.andsager@rolls-royce.com

[i] Rolls-Royce is a world-leading provider of power systems and services for use on land, at sea and in the air. We have a broad global customer base comprising more than 500 airlines, 4,000 corporate and utility aircraft and helicopter operators, 160 armed forces, more than 4,000 marine customers, including 70 navies, and energy customers in more than 80 countries.

We employ over 40,000 skilled people in offices, manufacturing and service facilities in over 50 countries, with our predominant operations and facilities in Europe and a significant element of our supply chain also based in Europe.

In 2011, Rolls-Royce invested £908 million on research and development, two thirds of which had the objective of further improving the environmental performance of our products, in particular reducing emissions. We support a global network of 28 University Technology Centres, which connect the company's engineers with the forefront of scientific research and our Group has a strong commitment to apprentice and graduate recruitment and to further developing employee skills.

Annual underlying revenues were £11.3 billion in 2011, of which more than half came from the provision of services. The order book stood at £62.2 billion at 31 December 2011, providing visibility of future levels of activity.

We believe we are the sort of company and business that the European economy needs to re-establish growth and an example the European Union (EU) would want to promote as part of their 'Europe 2020 Strategy' placing smart, sustainable and inclusive growth at the top of the European agenda.