SPECIFIC IMPACTS OF REGULATORY CHANGE ON END-USERS

INITIAL REPORT

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EXECUTIVE SUMMARY

The magnitude and far-reaching economic effects of the financial crisis have rightly led to reforms in the regulation of the financial sector with the intention of ensuring that such a crisis never happens again. The Institute of International Finance (IIF) supports the broad direction and ambition of the regulatory reform agenda, and is committed to working with the official sector to achieve the desired outcomes while avoiding unintended consequences.

There have been several studies by the official sector, private sector and academia which largely use macroeconomic analyses to provide some quantification of the potential net cumulative impact of these reforms on economic growth. The IIF contributed to this debate in September 2011 with a report titled "*The Cumulative Impact on the Global Economy of Changes in the Financial Regulatory Framework*". While individual reports vary in the estimate of the magnitude of the constraining impact of reforms on economic growth, even the most optimistic conclude that increased financial system safety will come at a cost to macroeconomic growth. However, regardless of the scale, **macroeconomic effects will not be spread evenly across all economic actors:** some may benefit and others may bear disproportionate costs.

To date there has been limited analysis of the direct and indirect effects of these regulatory changes on different classes of end-users of financial services.

This report is a preliminary, high-level consideration of some specific impacts of the reforms as they affect end-users. In order to do this, it considers the possible and actual effects on retail customers, small and medium-sized enterprises (SMEs), emerging market borrowers, large multinational corporates, and investors. The Report does not aim to provide a full and comprehensive analysis of all the impacts both positive and negative and the exact way in which they will change the economic landscape, but to provide a first picture of some matters that warrant further attention.

Three key findings emerge from this initial work:

i. Even before the full shape and content of financial reforms have been finalized, there are already **emerging observable impacts that are of concern.** As overall credit growth is adversely affected, many SMEs suffer as a result. Whereas most large well-established end-users are able to substitute funding from bank sources with funding from market sources - and are even helpfully seeing their cost of credit reduced in some cases - **smaller firms without this market access are seeing costs increased and access reduced.** There is a 'cliff' effect emerging between the larger and smaller firms, with smaller firms being severely impacted.

ii. We stress however that **the full impact of reforms on end-users has yet to materialize** because many reforms have yet to be finalized or implemented. There is evidence that some banks are currently absorbing costs from reforms already implemented pending clarity over the remaining reforms and are deferring modifying business strategies until there is such greater clarity. Once this interim phase is over, which may be some time, it seems inevitable that further costs will be passed on to end-users. The uncertainty over impacts for the financial industry, end-users and investors is seen to be affecting investment decisions.

iii. There is therefore **a need for continuing and deeper study of these impacts on end-users.** The IIF intends to carry out further analysis, and also recommends that the official sector engage in studying the combined behavioral effects. On the basis of such further work, regulators and policy makers will be in a much better position to identify whether there are reforms which need to be phased-in more carefully to mitigate the effects on particular groups of end-users, or calibrated more effectively to be sensitive to these impacts. As policy makers have acknowledged, the pursuit of financial stability should complement and support other efforts to deliver economic recovery and a return to sustainable economic growth.

INTRODUCTION

In July 2012, the IIF Board, concerned to understand better the impact of financial sector regulatory change on their customers, formed a Task Force to consider the Specific Impacts of Regulatory Change on the end-users of financial services.

Given the potential breadth of scope, the Task Force has focused its initial work on four segments seen as critical to economic recovery and a resilient financial sector: retail customers and SMEs; emerging markets; large multinational corporates; and institutional investors.

An important part of the exercise was direct engagement with end-users primarily through a survey process. In view of the preliminary nature of this work, the survey samples for each of the classes of end-users were deliberately small yet chosen so as to be representative and to highlight key issues of concern. We therefore take this opportunity to acknowledge the significant contribution of end-users to this report.

The Aim of the Report

This Initial Report is not intended to provide a comprehensive analysis of all the impacts and the exact way in which they will change the economic landscape. It does however, highlight some areas to be explored and the IIF will build on this initial analysis in the coming period. The IIF is keen to ensure that all policy makers, both regulators and those responsible for making economic choices, have the necessary information and insights to determine how the process of regulatory reform should be best managed, in magnitude and time.

The IIF is keen to start a dialogue with policy makers and those affected by regulatory change to consider the effects and how to strengthen the positive impacts and mitigate the negative ones.

The Structure of the Report

The first chapter provides background on the regulatory agenda and macroeconomic impact assessments, and an overview of the impact of reform on end-users.

Subsequent chapters consider specific impacts and areas of concern on four groups:

i. Retail Customers and SMEs;

ii. Emerging Markets;

iii. Large Multinational Corporates; and

iv. Institutional Investors.

The final chapter provides some concluding conclusions, preliminary recommendations and next steps.

CHAPTER 1. THE IMPACT OF REGULATORY CHANGE

Key Messages

Although regulatory reform encompasses many issues, this Initial Report focuses on four broad areas of regulatory reform that will impact end-users: (i) Basel rules, particularly the new prudential capital and liquidity reforms; (ii) reforms to securitization activity; (iii) derivatives requirements; and (iv) revised conduct of business regulation. Various studies have sought to quantify the macroeconomic impact of these reforms.

Our initial analysis suggests that, at an aggregate level, there are already signs that regulatory changes are leading to financial contraction and the reduction in the availability of credit to end-users.

THE REGULATORY AGENDA

In the light of the financial crisis, policy makers, regulators and the banking industry have a shared objective to put in place reforms to ensure a more stable and sustainable financial system.

Some of the necessary reforms will impact banks and other financial institutions but have little or no impact on end-users. However, among others, the following four broad areas of regulatory change will have a significant impact:

i. Basel rules, particularly the new prudential capital and liquidity reforms;

ii. Reforms to securitization;

iii. New requirements on derivatives; and

iv. Revised conduct of business regulation.

The new **capital standards** redefine more conservatively what counts as core capital, introduce a non-risk based leverage ratio requirement, and increase capital charges on some counterparty credit risk exposures. Further, a number of the secondary capital components will be treated more restrictively. The implementation of the new standards, including the introduction of additional components such as the capital conservation buffer and the counter-cyclical buffer, will by design increase the cost of intermediation and decrease the availability of bank credit to end-users.

The **Liquidity Coverage Ratio** (LCR) will, when fully implemented, require banks to hold significantly larger liquidity reserves than before, so strengthening balance sheets but adding a further constraint to credit generation. Further, the Net Stable Funding Ratio (NSFR) will require banks to achieve a marked reduction in maturity transformation. These reforms will create asset and liability biases that will negatively impact the provision of credit to end-users.

Proposed and actual securitization risk retention and disclosure rules, as well as uncertainty over the eligibility of asset backed securities in liquidity buffers, are already impacting the use of this channel for mortgage, auto, and other consumer lending. A recent consultation report[1] from the International Organization of Securities Commissions (IOSCO) also recognized that inconsistent implementation of requirements is likely to fragment the market along jurisdictional lines, further reducing liquidity in this sector.

G20 leaders have mandated centralized clearing of standardized **derivatives** and higher capital charges for non-cleared derivative products. These changes, designed to improve the transparency and pricing of risk management activity, will also have an impact on the cost and availability of important risk management products for end-users.

Policy makers have also identified that better protection of consumers and the improvement of **conduct of business regulations** are essential components of reform, focusing on mandatory information disclosures, design standards for financial products (particularly mortgages) and guidelines for behavior and business practices in dealing with customers. These changes will affect how banks interact with financial services end-users, both through the regulation itself and the cost of intermediation, and in so doing impact the economics of many products so that both supply and the customer segments served will likely shrink.

1 The Board of the International Organization of Securities Commissions: Global Developments in Securitization Regulation – Consultation Report, June 2012.

THE CUMULATIVE MACROECONOMIC IMPACT OF THESE CHANGES

Taken individually, and if implemented appropriately, most of the reforms have merit and will enhance the stability of the financial system. Improved systemic safety is a worthy objective but comes at a cost and a number of important studies have been completed assessing and quantifying the macroeconomic costs and benefits of the reform agenda.

In the official sector, several studies, including in particular from the Financial Stability Board, the Basel Committee and more recently the International Monetary Fund, have conducted impact assessments, concluding that modest reductions in economic growth and increases in lending spreads could be expected.

The IIF produced its own impact analysis, releasing an interim report in June 2010, followed by a final report in September 2011. The IIF reports concluded that overall the impacts could well be greater than official sector estimates, and that:

- Financial sector regulation is likely to raise banks' funding costs more than projected in other studies, with much of this increase likely transferred to banks' customers in the form of higher borrowing costs and/or reduced credit availability;
- Growth in bank credit to the private non-financial sector will be weaker; and
- There is a risk that impacts on credit cost and availability together will lead to noticeably weaker growth with a consequent negative effects on employment.

In addition, a number of private-sector financial firms in both developed and emerging markets have conducted similar macroeconomic impact assessments, some referencing the impact on their specific home country.

Regardless of the differences in estimates of the regulatory impact at the aggregate level, there is agreement among all studies that regulation will have at least some effect. This macro effect is unlikely to be evenly distributed among all sectors and individuals in an economy and even if the macro effect is small, the effect on some sectors may be particularly large.

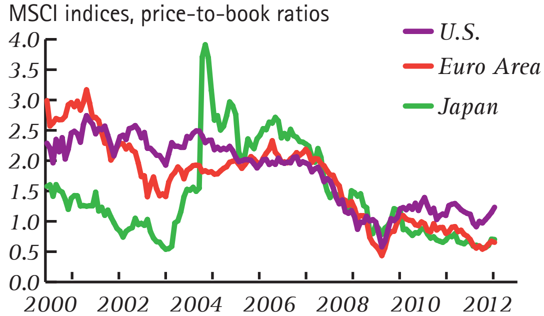
CURRENT FINANCIAL CONDITIONS

Current macroeconomic financial conditions are of concern. Bank funding costs remain elevated. Capital market conditions are severely impaired for banks, with many bank stock prices well below or just at their book value (Chart 1). At the same time, bank lending spreads have increased sharply in some jurisdictions to reflect higher funding costs (Chart 2), while bank credit supply has continued to be subdued (Chart 3). It is clear from the evidence compiled within this report that regulatory changes, including accelerated implementation of higher capital levels, are a contributing factor.

Chart 1

U.S, Japan and Euro Area: Bank Valuations

MSCI indices, price-to-book ratios

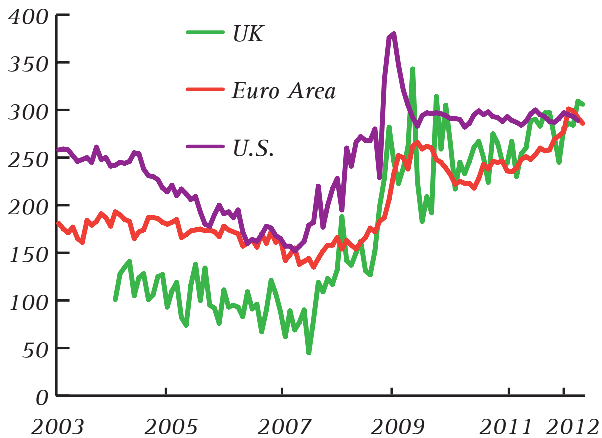


Source: MSCI

Chart 2

Bank Lending Spreads

basis points



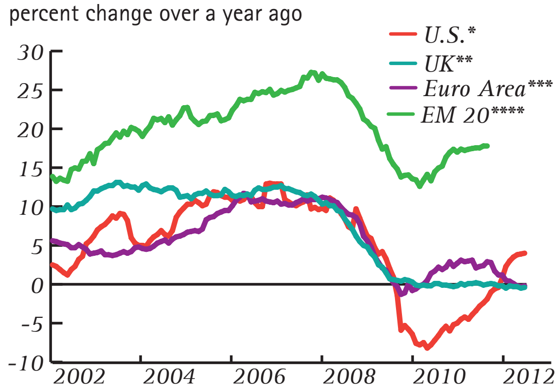
Source: Federal Reserve Board, Bank of England, European Central Bank (ECB)

*Difference between average of mortgage rate and interest rate on corporate loans and a weighted average of official rates and 10-year government bond yields.

Chart 3

Bank Lending to the Private Non-Financial Sector

percent change over a year ago



Source: Federal Reserve Board Bank of England, Thomson Reuters

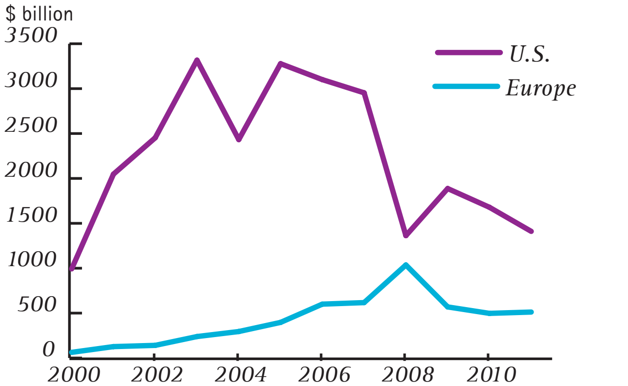
*Commercial bank C&I, consumer and real estate loans. ** M4 lending to private nonfinancial corporations and to individuals. *** MFI Loans to "other euro area residents". ****20 leading emerging market economies.

THE IMPACT ON END-USERS

At an aggregate level, there is clear evidence that financial activity volumes continue to face strong headwinds. Securitization volumes have decreased substantially in the U.S. and, to a lesser extent, in Europe (Chart 4). This is restraining growth in the origination of mortgage loans, holding back housing market recovery.

Chart 4

Securitization Issuance



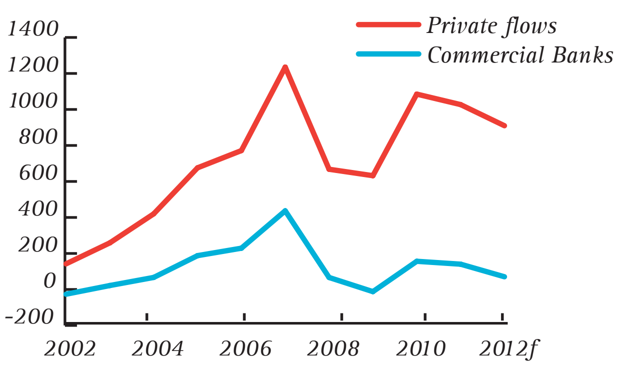
Sources: Bloomberg, Citigroup, Dealogic, Deutsche, JP Morgan, Bank of America Merrill Lynch, RBS, Thomson Reuters, Unicredit, AFME and SIFMA

Capital flows to emerging markets, although initially experiencing somewhat of a recovery after the initial shock of the crisis, are now showing a sustained downward trend (Chart 5). One key factor behind this is muted cross-border flows from commercial banks, particularly affecting certain countries in Emerging Europe such as the Baltic States and Hungary. This reflects to a large extent the deleveraging activities of Western European banks in response to the tighter capital and liquidity standards required by the European Banking Authority (EBA) as well as political pressure to concentrate activity in the home market.

Chart 5

Net Capital Flows to Emerging Markets

$ billion



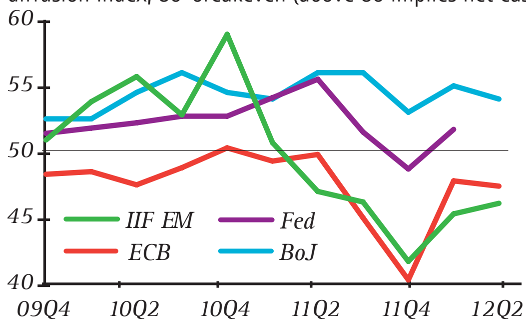
Source: IIF

Bank lending surveys have for many years been conducted by the major central banks in mature economies, while the IIF has been conducting an emerging market bank lending survey since 2009. These surveys, in line with the above comments, consistently point to tighter credit standards, notably in the Euro Area and in emerging markets (Chart 6).

Chart 6

Credit Standards for Corporate Loans

diffusion index, 50-breakeven (above 50 implies net easing)



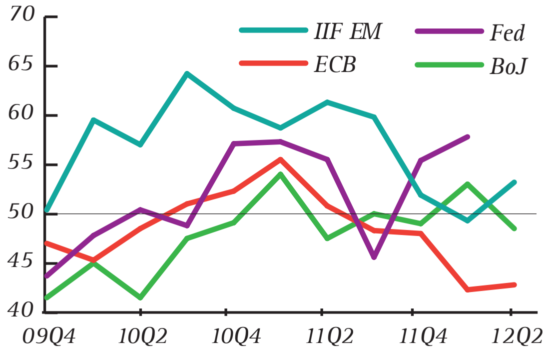
Sources: IIF Emerging Markets Lending Survey, Federal Reserve Board, ECB and Bank of Japan Bank Lending Surveys

Banks have also reported a decline in the demand for credit (Chart 7). While this is to some extent a reflection of difficult economic conditions, evidence is emerging that it is also due to a perception by borrowers that would be turned down.[2]

Chart 7

Demand for Corporate Loans

diffusion index, 50-breakeven (above 50 implies net increase)



Sources: IIF Emerging Markets Lending Survey, Federal Reserve Board, ECB and Bank of Japan Bank Lending Surveys

The European Commission Business Survey reports that 6% of surveyed companies see lack of finance as a factor that limits their production – close to the highest level for almost 30 years, although still low in absolute terms.

2 See for example Bank of England, Agents' Summary of Business Conditions August 2012, p.4: "Some businesses were refraining from applying for loans due to a perception that they would be unavailable". Similar evidence is reported for Ireland; see Holton, S. and F. McCann: Irish SME credit supply and demand: comparisons across surveys and countries, Central Bank of Ireland Economic Letter Series, Vol. 2012, No. 8.

While the tightening of credit standards may reflect other factors such as a cyclical reaction of banks to a weaker growth environment, **the evidence suggests that tighter regulation is a key factor.** Many banks reported in a recent survey by the European Central Bank (ECB) that regulatory requirements are impacting their decision to raise credit standards (Chart 8) and will continue to do so in the near future. Almost half of respondents reported that they have reduced their risk-weighted assets as a result of regulatory requirements. In large part increased capital ratios are being achieved through balance sheet deleveraging.

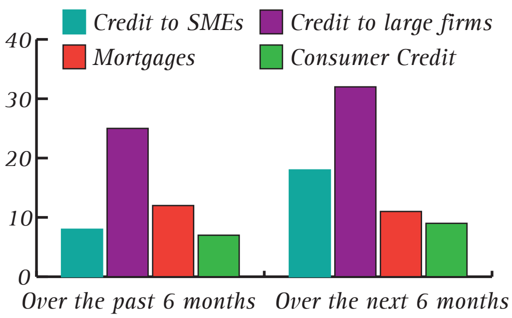
In the case of the U.S., more than half of banks responding to a recent Federal Reserve survey reported that **regulatory change was a "somewhat" or "very" important factor** in their decision to tighten credit standards (Chart 9).

These surveys and data show that at an aggregate level, end-users are already being impacted by reforms through diminished credit supply and tighter lending standards, even before the full extent of regulatory change is implemented. The following chapters consider further the impacts on specific end-user groups.

Chart 8

Euro Area: Impact of Regulatory Changes on Credit Standards

net percentage of respondents saying that requirements are impacting their decision to raise credit standards, as of July 2012

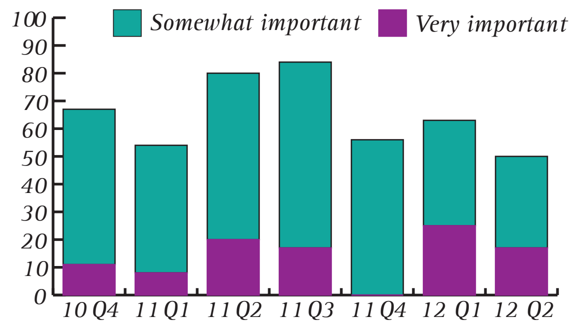


Source: ECB Bank Lending Survey

Chart 9

U.S.: Impact of Regulatory Changes on Credit Standards

percentage of respondents who reported tightening



Source: Federal Reserve Board - Senior Loan Officer Opinion Survey

CHAPTER 2. THE IMPACT ON RETAIL CUSTOMERS AND SMALL AND MEDIUM-SIZED ENTERPRISES

Key Messages

Retail customers and small and medium-sized enterprises (SMEs) are likely to be disproportionately affected by regulatory reform given their higher dependence on finance from banks and limited access to alternative sources. In addition, some regulations specifically affect this group of end-users, such as higher risk weightings for SME loans relative to large corporates or new risk retention requirements for securitization, which place constraints on mortgage lending.

The available evidence shows that retail and SME loan growth is declining and that this is linked to tighter supply conditions due at least in part to regulatory requirements. SMEs are reporting decreasing availability of external financing sources and higher costs, notably in the UK and the Euro Area. The majority of surveyed banks stated that they have changed the terms and conditions of mortgage lending in response to regulatory changes. This is most evidently impacting new borrowers and those with limited equity to contribute.

THE CHANNELS OF REGULATORY CHANGE

Increased regulatory pressure on banks can have a material effect on retail customers and SMEs as both are more dependent on bank financing than large corporate borrowers and have little option to alleviate this through finance from banks in other countries or wholesale markets. As a result of regulatory changes, **retail customers** are likely to find both the availability of credit reduced and its cost increased, particularly when attempting to finance home purchases.

The higher minimum capital ratios envisaged under Basel III mean that more capital will be required if lending rates are to be maintained. Margins have to be sufficient to attract capital and the greater cost burden will lead to upward pressure on the pricing of consumer credit, and potentially restrictions in supply.[3] Compared to pre-crisis rates, the full effects may be somewhat masked by very low central bank rates but some studies indicate that increased consumer protection requirements could also add an additional significant cost to consumer credit.[4] At the same time, the banks' requirements for increased liquidity is heightening competition for consumer deposits, benefiting depositors but putting further pressure on margins.[5] Unpicking these effects is critical as the broad macroeconomic analysis may mask the microeconomic effects – in this case borrowers not only bearing the majority of the cost of reforms but also bearing the cost of the benefit accruing to depositors. Changes to the definition of capital, risk weightings, and risk retention will have similar effects to the higher capital requirements.

Equally, conduct of business regulations on mortgage applications requiring greater transparency and disclosure will increase the cost of mortgage administration. In Canada, legislation requiring shorter retail mortgage amortization periods is expected to result in a 26% increase in monthly payments on an average mortgage with a minimum down payment.[6]

For SMEs, the risk weighted asset factors are comparable to consumer credit, with similar results. This will be heightened where there are changes which make other sectors relatively more attractive. In comparison, the requirement for AAA rated corporates is substantially lower.[7] As a consequence, banks under pressure to reduce their capital burden under Basel III may well look first to reduce higher risk-weighted assets, including SME loans and advances. The LCR, on top of this, places a direct requirement on banks to hold a significantly higher proportion of their balance sheet assets in sovereign debt, resulting in a crowding out effect.[8]

3 In Europe, McKinsey has estimated that the impact of prudential regulation on credit cards would mean that German banks need to raise prices by 328 basis points, and Italian banks by 441 basis points, to recover increased costs. See McKinsey, Day of Reckoning for European retail banking, July 2012

4 Josh Wright (George Mason University) and David Evans (University of Chicago), The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit, Loyola Consumer Law Review, Vol. 22, No.3, 2010, pp.277-335.

5 Oliver Wyman, Basel III Impact, (2011)

6 Aron Gampel, Adrienne Warren and Mary Webb, Scotia Economics, Special Report Canadian Housing, August 8, 2012

7 In Europe, a proposal to lower the risk weights of SME loans for exposures below a certain threshold is currently being discussed.

8 Bundesverband, Bank Regulation: Requirements and Positions of Small and Medium-Sized Enterprises, Policy Brief 2010, October, 2010.

The NSFR will provide a direct incentive to reduce loan maturities to less than a year.[9] This will constrain the ability of businesses to access longer term funding from the banking sector needed to undertake investments that contribute to long term growth. It is unclear where this funding will come from in the future.

THE AVAILABLE EVIDENCE

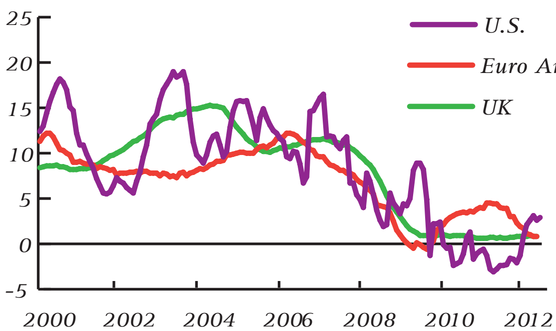
While the available evidence suggests that retail customers and SMEs in particular are facing tighter credit conditions, loan growth has been rationed by strict credit standards driven to a significant degree by regulatory changes. Credit demand has fallen as businesses adjust to new prices and stricter credit criteria in an already weak macroeconomic environment. The result is a vicious circle which requires concerted action on both the supply and demand elements if the effects are to be mitigated.

Growth in SME loans, mortgages and other consumer credit has been declining substantially from the pre-crisis period and in many countries outstanding volumes are stagnating (Charts 10 and 11). While loans to SMEs are still increasing in France, the rate at which they are growing has been falling (Chart 12).

Chart 10

U.S., Euro Area and UK Mortgage Lending

percentage change over a year ago

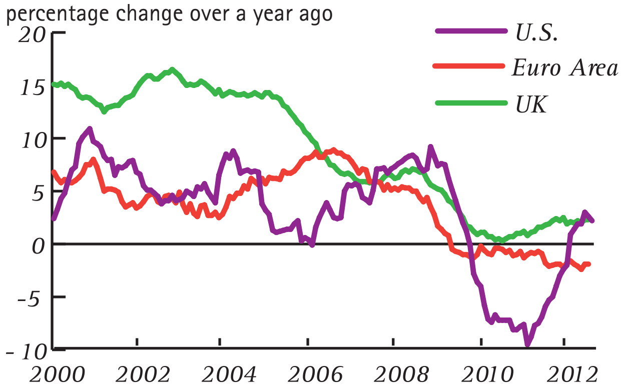


Sources: Bank of England, Federal Reserve Board and ECB

Chart 11

U.S., Euro Area and UK Consumer Credit

percentage change over a year ago

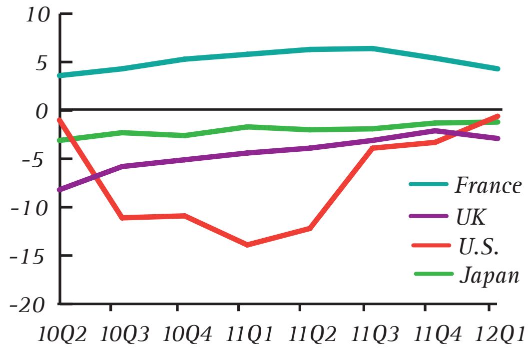


Sources: Bank of England, Federal Reserve Board and ECB

Chart 12

Major Economies: Small Business Loans

percent change over a year ago



Sources: Bank of England, Banque de France, Bank of Japan, Federal Deposit Insurance Corporation

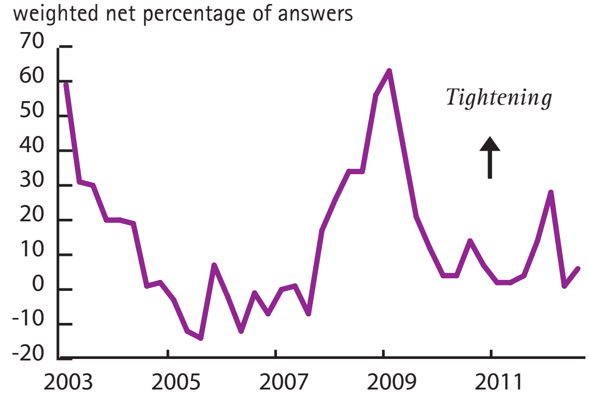
Bank lending surveys indicate clearly that this outcome is related to tighter credit standards. Even though the pace of tightening may have decreased compared to the immediate post-crisis period, it has picked up more recently in the Euro Area. There has also been a clear increase in the pricing of smaller loans, which can serve as a proxy for SME loans, relative to larger loans, and SMEs report decreasing availability of external finance sources (Charts 13-16).

In the case of the UK, the fall in the availability of credit to smaller firms is a more recent phenomenon, and is now turning as the British Government introduces a number of schemes to offset funding constraints seen in the market. Specifically, the costs for SME credit have increased and conditions have tightened (Charts 17 and 18). In the U.S., credit standards are currently easing somewhat for business and retail loans but this barely compensates for the substantial tightening that occurred earlier (Charts 19 and 20).

Chart 13

Euro Area: Bank Credit Standards to SMEs

weighted net percentage of answers



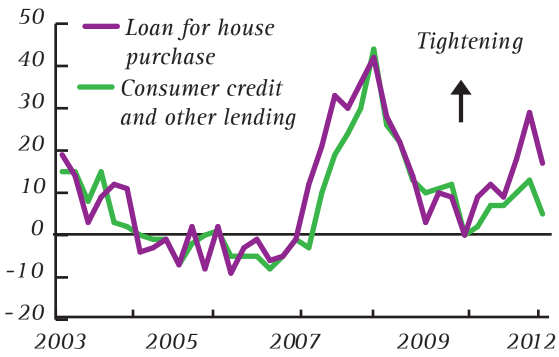
Source: ECB Bank Lending Survey

9 Oliver Wyman, Basel III Impact, (2011)

Chart 14

Euro Area: Credit Standards for Household Loans

weighted net percentage of respondents

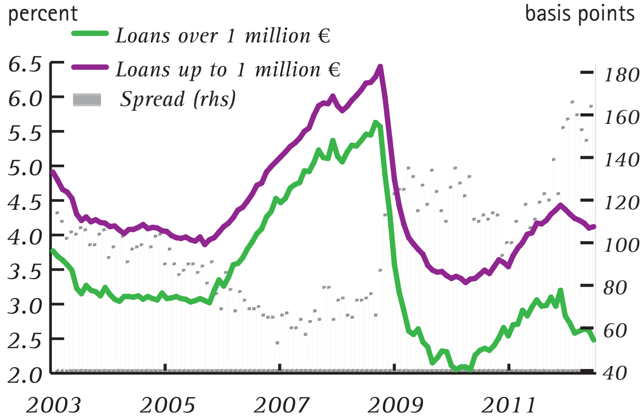


Source: ECB Bank Lending Survey

Chart 15

Euro Area: Interest Charged on Loans to Businesses

percent basis points

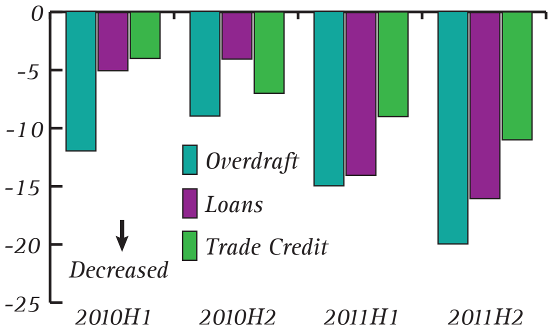


Source: ECB

Chart 16

Euro Area: Availability of External Financing Sources

net percentage of answers

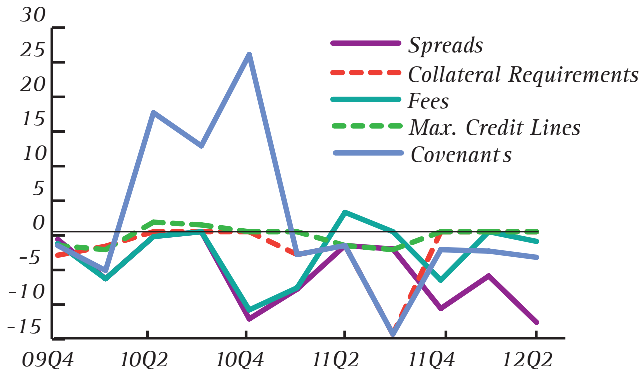


Source: ECB Bank Lending Survey

Chart 17

UK: Cost of and Conditions for SME Credit

net percentage balance

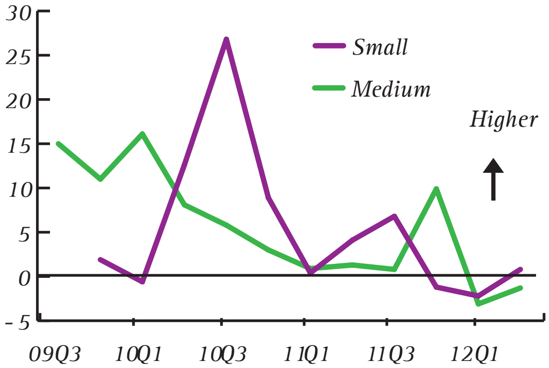


Source: Bank of England Credit Conditions Survey

Chart 18

U.K.: Availability of Corporate Credit

net percentage balance

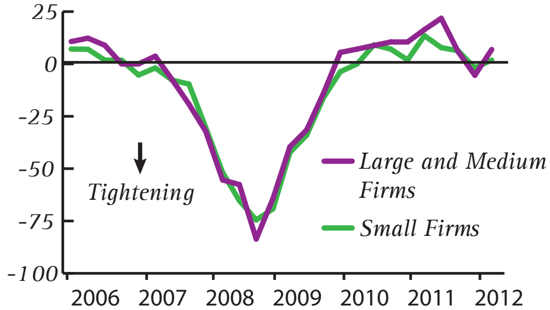


Source: Bank of England Credit Conditions Survey

Chart 19

U.S.: Credit Standards for Commercial and Industrial Loans

net percentage of answers

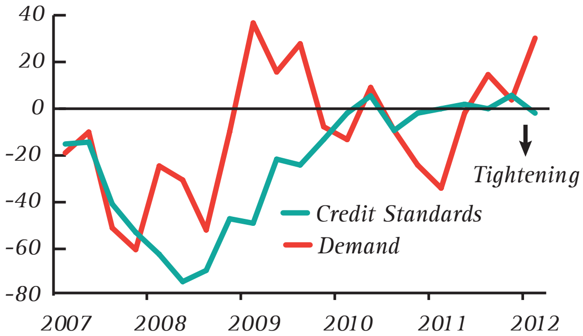


Source: Federal Reserve Board Senior Loan Officers Opinion Survey

Chart 20

U.S.: Mortgage Conditions

net percentage of answers



Sources: Federal Reserve Board Senior Loan Officers Opinion Survey

The evidence of increasingly difficult access to credit is confirmed by surveys of businesses, which clearly state that credit for SMEs is less available.

According to the U.S. National Small Business Association (NSBA), 57% of SMEs in the U.S. have needed funds over the last four years but were unable to obtain them.[10] In Germany, 24% of SMEs were reported to have been unsuccessful in their credit application, compared to 15% of SMEs in 2007.[11]

Businesses suggest that regulatory change is a driving factor behind this tightening in credit standards for SMEs. For example, the European Association of Craft and SME Enterprises expressed worries that the capital requirement rules – in conjunction with other regulatory initiatives – could impede the flow of loans to SMEs.[12] According to the German Bundesverband Mittelständische Wirtschaft, the implementation of Basel III alone would lower the SME credit volume and would lead to a widening in the interest rate spread.[13] In addition, they are increasingly worried about the liquidity ratio and its impact on the likely shortening of maturity for loans. Similarly, the Confederation of British Industry has raised a concern that banks' response to regulatory reforms could be a shift away from lending, such as SME credit, that requires higher capital and produces relatively low returns.[14] They point out that the debate over whether access to finance is a supply or demand issue is "acute" for SMEs, and note that although demand may be low, "there is a nagging reality that some viable demand is not being met." For emerging markets, McKinsey reports of significant unmet credit needs and that the regulatory environment is one barrier.[15]

THE EVIDENCE FROM QUESTIONNAIRES

Some of the comments received:

"The Government in the UK is proposing a mandatory split of universal banks into retail and wholesale operations but the terms on which this is to be undertaken have not been clarified as yet."

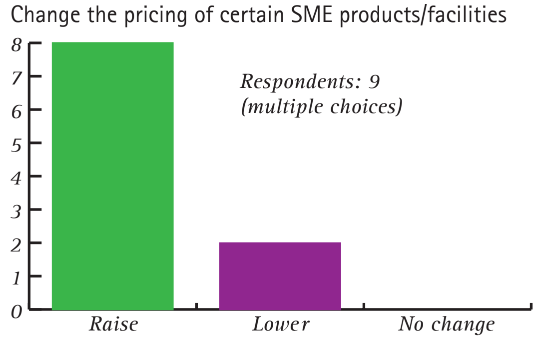
"The result of the structural reforms of banking currently underway in Europe (...) will affect the classification of corporate clients as a large corporate or as a SME and which banking activities and services are considered wholesale or retail banking. Depending on the final rules approved we may consider to reallocate our activities."

- A theme in our interactions with lenders is the current lack of clarity on the regulatory agenda which is preventing banks from adequately preparing for some of the sweeping regulatory changes underway.
- The full impact of regulatory changes remains elusive as the final outcome of regulatory reforms may or may not impact specific activities, prompting potential reallocation of broad business segments.

Chart 21

Regarding SME loans, have you implemented or are you considering the following in response to regulatory change?

Change the pricing of certain SME products/facilities



Source: IIF

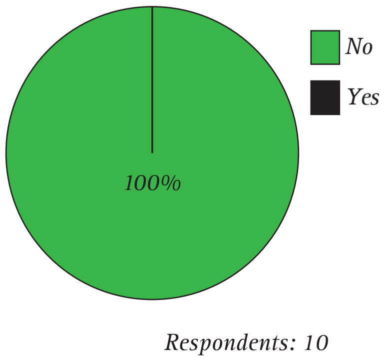
- The survey participants indicated in a number of instances that they had changed the pricing of mortgage and consumer loan products in a variety of ways.
- While product pricing seems to be the main channel through which banks are responding to the impact of regulatory changes, a number of respondents indicated that they also have considered running down products such as long-term mortgage loans, or increasing fees and limiting fee exemptions.

10 See NSBA: Small Business Access to Capital Survey, 2012.
11 See Statistisches Bundesamt Deutschland: Finanzierung: Der Zugang kleiner und mittlerer Unternehmen zu Finanzmitteln, July 2011.
12 See http://www.ueapme.com/IMG/pdf/111123_pp_CRD-IV_UEAPME.pdf
13 See http://www.bvmw.de/uploads/media/verbaendebrief.pdf
14 See CBI, Financing for growth: Refocused finance for a rebalanced economy, July 2012

15 See McKinsey and IFC, Two trillion and counting, Assessing the credit gap for micro, small, and medium-sized enterprises in the developing world, 2010.

Chart 22

Is there sufficient clarity in the regulatory change agenda for you to assess the full impact on your lending business?



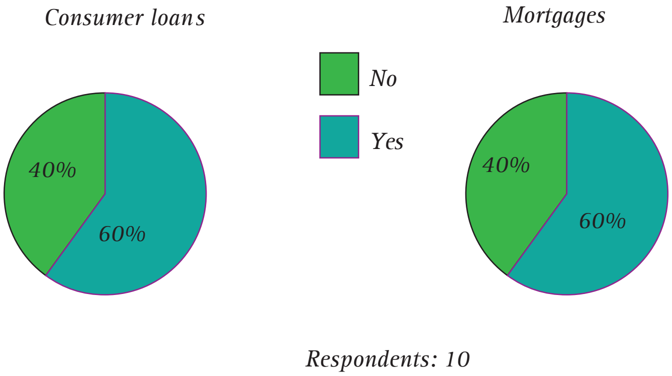
Source: IIF

- SME loan products seem to have become more expensive across the board, and importantly most respondents indicated that they increased prices for all types of loans in response to regulatory changes.
- Several participants also indicated a tightening in SME loan terms and conditions, particularly a shortening in loan maturities.

Chart 23

Have you implemented or are you considering the following in response to regulatory change?

Change the pricing of certain...



Source: IIF

When asked about specific loan products affected, those surveyed replied:

"Standard variable rate in mortgage loans"

"Loan application fee"

"Across all mortgage products"

"Interchange credit cards"

"Credit cards and overdraft"

When asked about SME products affected, those surveyed replied:

"All facilities, especially medium/long-term loans."

"Loan products"

"Overall, to reflect the higher capital and funding costs"

"Increased lending margins reflecting higher capital requirements"

CHAPTER 3. THE IMPACT ON EMERGING MARKET BORROWERS

Key Messages

Emerging market end-users are experiencing impacts through two channels: directly, as local regulators implement the international reform agenda; and indirectly, as global banks adjust to the new regime—a process which is expected to result in further deleveraging. The preliminary results of our analysis suggest that the cost of funding has increased—notably for smaller companies. Many emerging market firms also anticipate future constraints on funding and still higher costs over the next 12 months, once the impact of new reforms materializes.

That said, the evidence that many emerging market firms are facing higher funding costs—in an environment of sustained ultra-low interest rates—suggests that constraints on the supply of credit may be a significant factor. Banks are likely to continue to respond to higher capital and liquidity requirements by trimming risk assets—including credit provision to overseas markets. A carefully calibrated implementation timetable is key to avoiding the negative feedback loop from higher costs of financing in emerging markets while mature markets resolve domestic challenges.

THE CHANNELS OF REGULATORY CHANGE

In assessing the potential or actual channels through which regulatory changes could impact emerging markets, we have identified three sets of reforms that are having, or are expected to have, an impact:

i. The **Basel capital and liquidity framework;**

ii. **Over The Counter (OTC) Derivatives** regulations; and

iii. **Rules of other jurisdictions** with a far-reaching impact.

As noted in Chapter 1 above, **higher capital requirements and tighter definitions of capital** under Basel III are likely to raise the cost of credit and reduce its availability to borrowers, including those in emerging markets.

The **Basel 2.5 reforms,** particularly the adoption of "stressed value-at-risk", and the incremental risk capital charge will diminish banks' appetite to hold emerging market assets in trading books given their typically higher volatility and lower credit ratings.

The **CVA capital charge** affects lower-rated counterparties, volatile markets and cross-border derivatives all to a greater extent than, plain vanilla single currency/ developed market derivatives transactions with highly rated counterparties. This will impact the cost and provision of long-term cross-border funding such as project finance where derivatives are used to manage risks.

Rules on Global Systemically Important Banks (G-SIBs) and Domestically Systemically Important Banks (D-SIBs), the weighting for cross-border activities in the G-SIB assessment methodology and additional capital requirement for G-SIBs and D-SIBs could further constrain international lending activities in those markets and reduce credit availability in emerging markets.

Liquidity rules will exacerbate this. The LCR, which requires banks to hold large quantities of liquid assets, will disproportionately impact emerging markets that have a limited supply of these assets. The consequential hoarding of liquid assets by banks will serve to reduce liquidity in domestic bond markets. The NSFR, by requiring greater maturity matching, will weaken bank demand for longer-term investments in emerging markets, including export finance.

Leverage rules are expected to affect the availability and cost of trade finance for emerging market businesses.

OTC derivatives regulations requiring the standardization and centralized clearing of OTC derivatives will potentially drive up hedging costs for end-users in emerging markets where these facilities may not be available, particularly for cross-border and commodities hedging.

Two **rules of external jurisdictions** with particular impact on emerging markets are the proposed **Volcker Rule** and the **Foreign Account Tax Compliance Act** (FATCA). The proposed Volcker Rule prohibits affiliates of U.S. banks in other countries from engaging in proprietary trading of these countries' government securities and thus is likely to negatively impact on the liquidity of securities and derivatives markets in emerging markets. FATCA, which is designed to give the U.S. Internal Revenue Service a means to stop U.S. taxpayers with offshore accounts evading U.S. taxes, will also affect emerging market banks, who will likely choose not to serve U.S. clients due to the high cost of compliance. These may be legitimate goals but the mechanism by which they are applied may reduce the overall appetite of banks to do business in these countries.

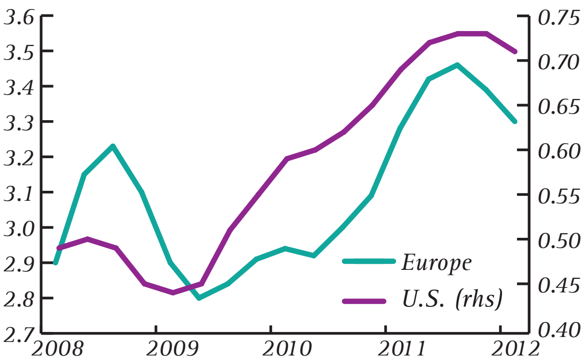
THE AVAILABLE EVIDENCE

After a strong recovery from the lows of the global financial crisis, banks in both Europe and the U.S. have begun to cut back on lending to emerging market borrowers (sovereign, financial and corporate, Chart 24). **While concerns about global growth prospects play a role in this retrenchment, emerging market lending is also a prime area within the realm of "risk assets" where banks can deleverage and improve capital ratios and more importantly be seen to bring capital and liquidity back to their home markets.** One area that has seen particular weakness is long-term specialty finance (Chart 25). Term structured credit in areas including aircraft and shipping may be more vulnerable given long maturities and dependence on term dollar funding. Similarly, trade finance flows—areas where Euro Area banks have been dominant—have also been weaker (Chart 26).

Chart 24

Mortgage Banks' Exposure to Emerging Markets

$ billion, three quarter moving average

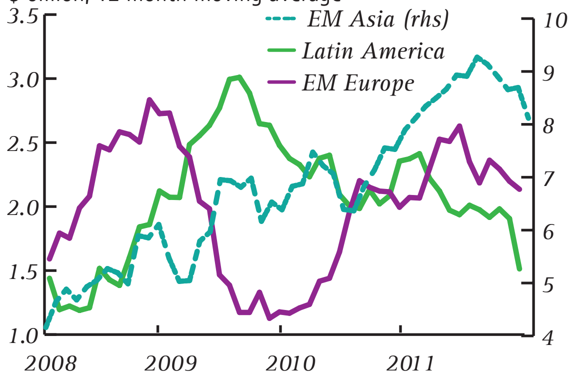


Source: Bank for International Settlements

Chart 25

Long-Term Specialty Finance in Emerging Markets

$ billion, 12 month moving average

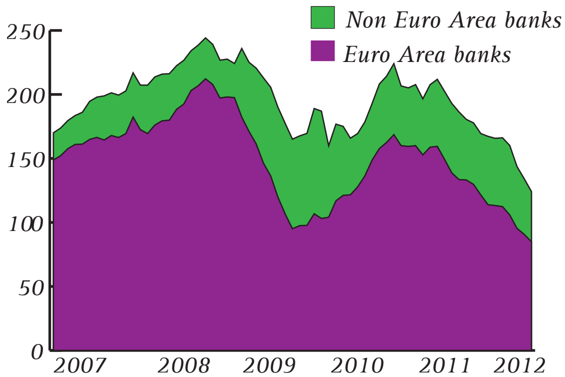


Source: International Monetary Fund

Chart 26

Selected Trade Finance Flows

$ billion, 12 month flows



Sources: Bank of England, Dealogic

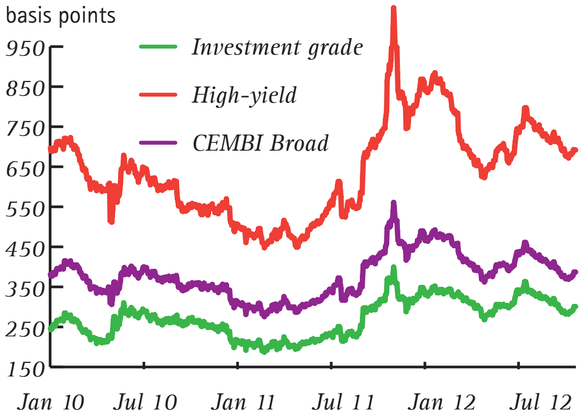
Emerging economies that are highly dependent on external funding are more vulnerable to global bank retrenchment.

Regulatory requirements, such as discretionary ring-fencing of national financial systems, can increase regulatory uncertainty, reduce investment and hamper the optimal allocation of capital. This **affects banks directly and end-users such as emerging market corporate borrowers indirectly, particularly via higher funding costs.** Emerging market corporate bond spreads are notably above year-ago-levels (Chart 27), and are persistently above pre-crisis levels (Chart 28). Again, part of this can be attributed to uncertainty about global growth prospects. But against a backdrop of strong demand for emerging market fixed-income investments and an upward reassessment of prospects for emerging market assets more generally, higher funding costs may also reflect regulatory pressure on banks and investors to de-risk balance sheets and portfolios.

Chart 27

Emerging Market Corporate Bond Spreads

basis points

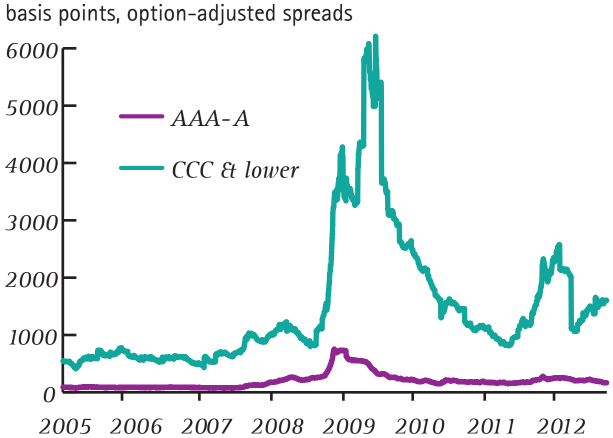


Source: JP Morgan

Chart 28

Emerging Market Corporate Bond Spreads

basis points, option-adjusted spreads



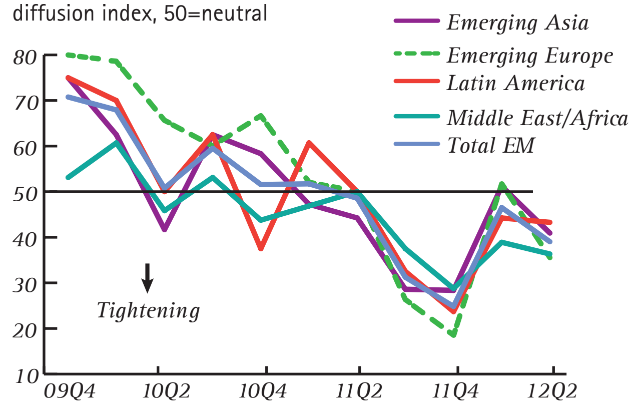
Source: Merrill Lynch

Both heightened risk aversion from the European sovereign debt crisis and higher capital requirements are contributing to a diminished availability of capital on international funding markets (Chart 29), pushing emerging market banks and end-users to rely increasingly on domestic sources of funding. However, emerging market banks in some regions appear to have less appetite and capacity to provide funding in areas such as trade finance (Chart 30).

Chart 29

International Funding Conditions

diffusion index, 50=neutral

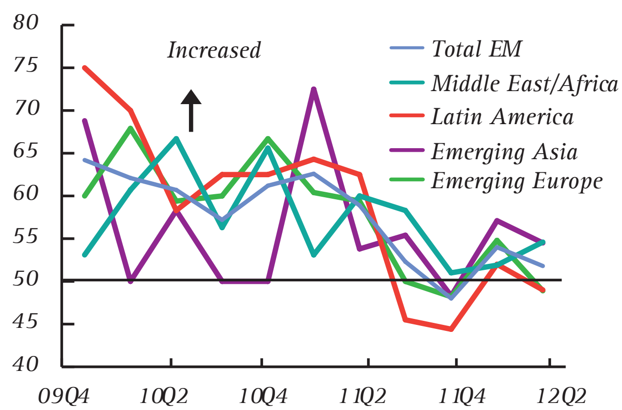


Source: IIF Emerging Market Lending Survey

Chart 30

Willingness to Supply Trade Finance

diffusion index, 50=neutral



Source: IIF Emerging Market Lending Survey

NB: The Emerging Market Lending Survey is a quarterly survey of over 130 banks based in emerging markets. Global and regional diffusion indices, represented above, are calculated based on the answers of individual banks (see IIF website for more information).

Looking at the longer-term picture, emerging market corporate bond spreads remain elevated. The difference between the spread on CCC/lower-rated borrowers and that on AAA-A borrowers is notably high, highlighting the funding challenges for lower-rated borrowers.

THE EVIDENCE FROM QUESTIONNAIRES

The majority of respondents (emerging market corporates for the most part) noticed an increase in the cost of financing - especially for credit lines, trade finance and derivatives - over the last twelve months (with credit terms and conditions tightening too). A large majority of participants believe that regulatory changes are responsible for this cost increase, and half of them expect these changes to affect their business activities and investment decisions.

Comments from respondents included:

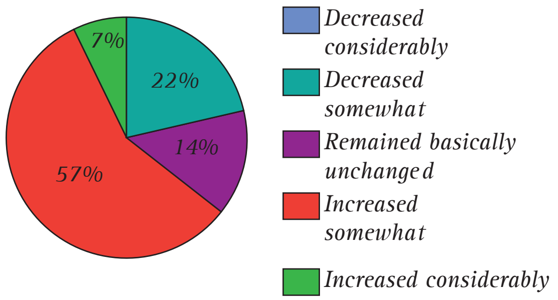
"... We expect major impact of the evolving regulatory changes on our business (sic). These are mainly related to higher capital requirements (Basel III, D-SIB etc.), liquidity ratios (LCR, NSFR) and trading book regulations (Basel 2.5 etc.)"

"To some cases the European Banks starting to cherry pick the eligible and acceptable industries and companies (sic)".

"...loans and credit conditions / pricing for our customers have been somewhat tightened over the past twelve months. This is mainly to account for regulatory capital that banks are required to maintain on such credits."

Chart 31

Over the last twelve months, how has your overall cost of financing changed?

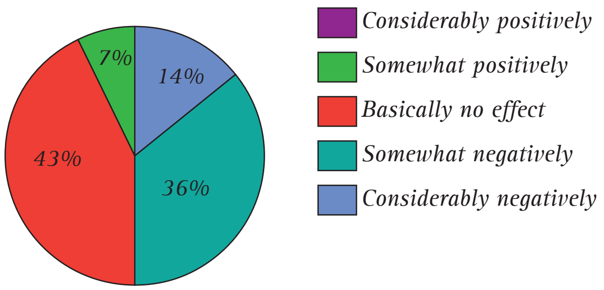


Respondents: 14

Source: IIF

Chart 32

Over the last twelve months, how do you expect regulatory changes to affect your business activities and investment decisions?

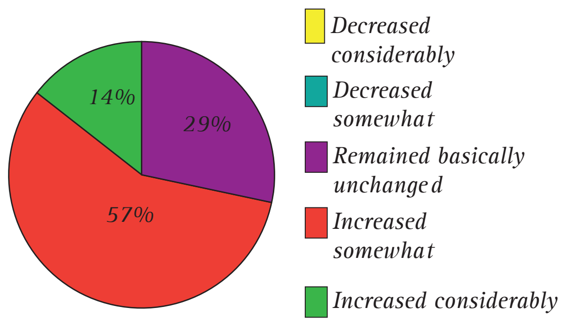


Respondents: 14

Source: IIF

Chart 33

Do you believe that any regulatory change has passed through to you in terms of higher prices over the last twelve months?

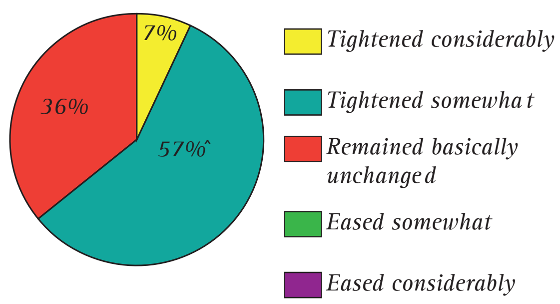


Respondents: 14

Source: IIF

Chart 34

Over the last twelve months, how have terms and conditions for loans and lines of credit changed?



Respondents: 14

Source: IIF

CHAPTER 4. THE IMPACT ON LARGE MULTINATIONAL CORPORATES

Key Messages

Large Multinational Corporates (LMCs) are traditionally less reliant on bank financing than SMEs. However, they are not immune to the effects of the financial sector regulatory changes being implemented.

The available evidence is that LMCs are increasingly seeking non-bank sources of funding, faced with the prospect of increased costs of bank funding. This funding strategy could however be affected by the current negotiations on changes to the EU's Markets in Financial Instruments Directive (MiFID), while OTC derivatives regulation could affect a number of LMC business models.

LMCs contribute significantly to global output and employment. In order to avoid any critical effects on their functioning, it is essential to ensure that regulatory changes deliver the right balance of financial stability and sustainable economic growth.

THE CHANNELS OF REGULATORY CHANGE

The IIF has identified five potential channels through which LMCs could be affected, many of them similar to those identified for retail customers, SMEs and emerging markets:

i. the Basel III framework;

ii. the proposed Volcker Rule;

iii. the MiFID II proposal;

iv. OTC derivatives regulations; and

v. the proposed approach to Globally Systemically Important Financial Institutions (G-SIFIs).

The higher capital ratios under **Basel III** will increase bank funding costs and this increase is likely to be passed, at least partially, onto LMCs. The liquidity measures will also increase funding costs. The LCR is particularly punitive towards liquidity lines, which will increase costs and reduce the availability of these facilities, driving LMCs to hoard cash as an alternative liquidity risk mitigant. This is likely to reduce their ability to reinvest profits in their businesses, and in turn reduce growth and employment.

The impacts will be greater the longer the term of financing, making project finance, which has typically very long maturities, increasingly expensive and scarce. Our preliminary survey results show that certain LMCs with a good and stable rating and easy access to capital markets are turning increasingly from bank financing, resulting in reduced credit costs. However those that cannot access capital markets directly must rely on bank financing, creating a "cliff" effect.

The proposed **Volcker Rule** could have negative effects on market making and reduce liquidity for many securities. One recent study calculated that for American LMCs the annual cost of issuing bonds could increase substantially as a result of the proposed rule.[16] A second study highlighted the negative impact on growth and consequent impact on employment that can be directly attributed to these increased funding costs.[17]

European LMCs are likely to be impacted by the **proposed revisions to MiFID.** European bank holdings of corporate bonds nearly tripled in the 2005-09 period, though they have been stable or declining since then. Concerns over the price transparency rules for corporate bond trading under the proposed MiFID revisions could further reduce these holdings, adversely affecting the liquidity of European corporate bond markets (particularly for already less liquid bonds), increasing the cost of financing and making refinancing of the upcoming 4.2 trillion in corporate bonds maturing in 2016 more challenging.[18]

The CVA risk capital charge will increase the cost of **derivatives**, particularly long-dated trades.[19] The CVA charge could be avoided through central clearing or posting margin, but either of these paths significantly increases cash flow volatility and can present a significant liquidity risk to LMCs. Recent proposals published by the European Systemic Risk Board suggest that very few corporates in Europe will be exempt from using central counterparties and posting

16 Oliver Wyman , The Volcker Rule Restrictions on Proprietary Trading, p. 4.
17 U.S. Chamber of Commerce Center for Capital Markets Competitiveness, The Economic Consequences Of The Volcker Rule, p. 19 ff.
18 With a fully transparent trading regime, the market would know the prices other dealers paid for positions, leading to smaller dealer inventories of less-liquid bonds and making these bonds even more illiquid.
19 S&P, Why Basel III And Solvency II Will Hurt Corporate Borrowing In Europe More Than In The U.S., p. 6.

margin, further increasing their need for standby cash resources.

There is a risk that LMCs could stop using derivatives for risk management purposes given the expected pricing increases, moving financial market risk from the financial sector onto end-users.[20]

G-SIBs have already started to deleverage significantly. The capital surcharge could lead G-SIBs to increase the price of credit for businesses or even reduce the availability of credit for some businesses, as noted earlier.[21]

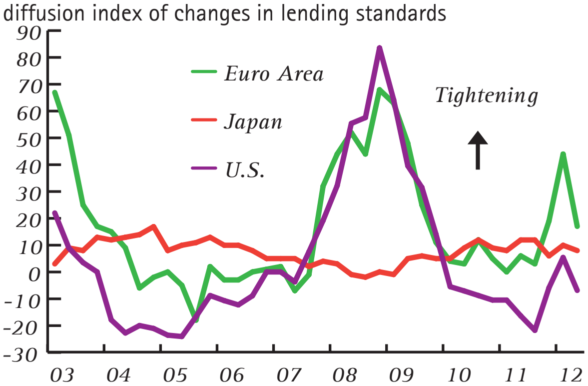
THE AVAILABLE EVIDENCE

Central bank lending surveys provide evidence of **credit tightening** to large corporates (Chart 35). Moreover, according to the ECB Survey, a significant percentage of banks reported tightening because of Basel III and other regulatory requirements (Chart 36).

Chart 35

G3: Bank Lending Standards to Large Corporates

diffusion index of changes in lending standards

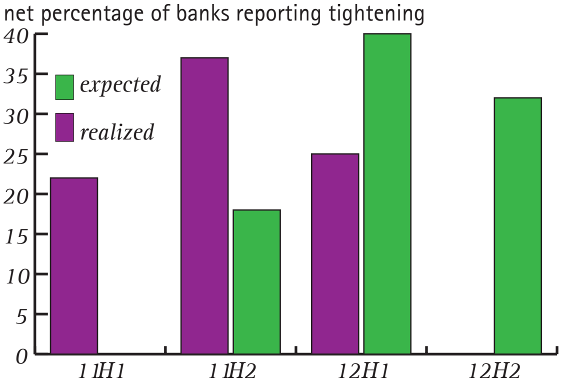


Sources: Federal Reserve Board, Bank of Japan, ECB Bank Lending Surveys

Chart 36

Tightening in Lending to Large Euro Area Corporates due to Basel III and other regulatory requirements

net percentage of banks reporting tightening



Source: ECB Bank Lending Survey

20 An example of an industry likely to be significantly damaged by the CVA charge is the airline industry. See Michael Watt, Corporates fear CVA charge will make hedging too expensive, Risk magazine, 3 October 2011.
21 S&P, Why Basel III And Solvency II Will Hurt Corporate Borrowing In Europe More Than In The U.S., p. 4.

While the full impact of this tightening has been cushioned by lower than normal corporate demand for bank loans, tighter credit conditions are likely to continue to act as a drag on growth even after loan demand from large corporates picks up. Indeed a large percentage of Japanese and U.S. banks reported increased demand in the second half of 2012.

The effect of this is that LMCs are relying increasingly on capital markets. In 2012, large U.S. corporates raised some $386 billion just by mid-August in bond markets at record low interest rates. In Europe, corporate bond issuance overtook corporate lending in early 2009 and again in Q1 2012, as lending declined sharply.

U.S. securities dealers have sharply reduced their inventories of corporate bonds - to about $45 billion from $235 billion in 2007, a decline of over 80%. Over the same period, the size of the U.S. corporate bond market has doubled to $8 trillion, making the liquidity effects of shrinking dealer inventories more pronounced. Smaller inventories carried by dealers have resulted in consistently lower trade volumes, while relatively new benchmark issues have been taking up a larger proportion of market liquidity.

A recent survey of **derivatives** end-users[22] indicates that the higher margin and capital costs placed on counterparties as a result of the Dodd-Frank Act are likely to raise transaction costs associated with the use of derivatives for risk mitigation.

THE EVIDENCE FROM QUESTIONNAIRES

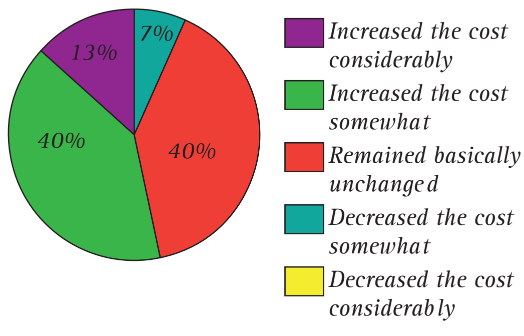
We surveyed a number of large corporates with global operations. Most respondents reported that credit availability and prices had remained unchanged or increased somewhat. However, there was some evidence that these trends were a result of direct capital market financing replacing bank financing. The majority of the respondents also reported that the cost of liquidity facilities and trade finance had increased.

When asked about the impact of regulatory changes, over half of respondents indicated that they believed that these have already impacted the cost of financing. Over three-quarters expected that their future investment decisions will be negatively affected by the changes.

22 Coalition for Derivatives End-Users Survey. Conducted for 74 non-financial US companies with $1 trillion in revenues and 2 million employees, as of end 2010.

Chart 37

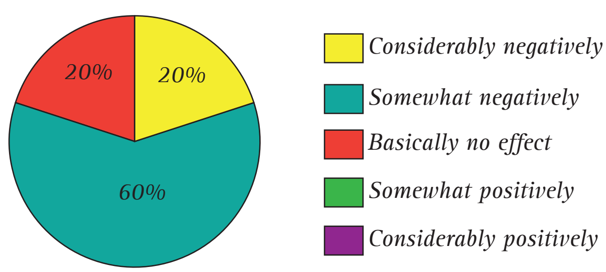
To what extent do you believe that regulatory change in the financial sector has contributed to the cost of financing?



Source: IIF

Chart 38

Over the next twelve months, how do you expect financial sector regulatory changes to affect your business activities and investment decisions?

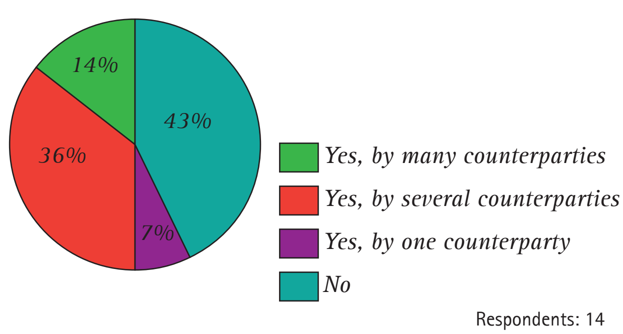


Source: IIF

The survey also provides an indication of the initial impacts of derivatives regulations, with more respondents reporting that they have been approached by their counterparties about committing to initial margin/variation margin requirements than not.

Chart 39

Have you been approached by your derivative counterparties to commit to initial margin/variation margin requirements for derivative contracts?



Source: IIF

Comments received from survey participants:

"Besides the upcoming problems for corporate treasuries with regard to prices and product availability, we feel that corporates are somewhat taken into joint liability with banks for the financial crises, as they often have to comply with the same set of stricter rules as financial institutions. This is not justified, as corporate end-users have not contributed to any of the recent turbulences in financial markets. Nevertheless, corporates are being forced to carry significant parts of the resulting cost increases".

"After the adoption of Basel 3 we think [banks'] funding cost will raise and at the same time requirement for their profitability will be stronger (sic). As a result funding might be the biggest obstacle to our business."

"[...] these effects, partially multiplied by overlapping regulation, will increase overall risk for corporate end-users, e.g. due to cost increases in hedging products, or the discontinuation of tailor-made product solutions."

CHAPTER 5. INVESTORS

Key Messages

For the purposes of this study, we have focused on two areas: (i) the impact of regulatory changes on investor appetite for bank equity and debt, and (ii) the impact on investors themselves.

Broadly, uncertainty about the regulatory environment for banks and its impact on their balance sheets, business models and returns is affecting the willingness of investors to provide bank funding—debt or equity—on an ongoing basis.

Banks have in recent years raised a significant amount of debt and equity; however, the cost of this capital raising has increased in many cases. Bond spreads—notably those for smaller or less well-capitalized banks, and for subordinated bank debt—remain at elevated levels, while bank price-to-book ratios remain well below pre-crisis levels, and in many cases well below book value. Investors are thus demanding higher returns from their investments in banks and are unlikely to recapitalize banks at current levels of return on equity.

Regulatory changes will diminish market liquidity in some sectors and materially increase the cost of some derivative products.

Some of these themes are evident in the questionnaire results. Two-thirds of investors surveyed believe that the regulatory agenda will lead to lower average holdings of bank equity by institutional investors, while over 90% believe that it will lead to lower holdings of long-term bank debt. Nearly two-thirds of investors surveyed believe that the combination of liquidity and margining reforms in OTC derivatives markets will require a significantly higher return and or/heavily restrict investment.

THE CHANNELS OF REGULATORY CHANGE

Investors - including asset managers, hedge funds, insurers, pension funds, and family offices - play a vital role in the financial markets. On the one hand, they are end-users of financial services, and trading securities and derivatives in the secondary markets.

On the other hand, they are also at the front end of the capital formation process, providing funds to banks through investment in their debt and equity. Any reluctance of investors to perform this function will inevitably have systemic repercussions for banks in their role as financial intermediaries and on other market participants at the back end of the capital formation process.

The IIF has identified three potential channels through which investors may be affected:

i. The **Basel framework**, including the definition of capital, the NSFR, capital surcharges for G-SIBs and D-SIBs and the introduction of bail-in resolutions;

ii. The proposed **Volcker Rule**; and

iii. **OTC Derivatives regulations.**

The new Basel framework has changed the definition of eligible bank equity significantly and G-SIBs and D-SIBs will be required to meet even higher thresholds of capital.

From an investor perspective, any decision to buy bank equity depends on an assessment that the business framework of the bank is stable and that it can achieve the envisaged return on equity. Hence, uncertainty about the regulatory environment for banks and its impact on their returns will deter investors from providing additional equity.

Beyond the equity measures, the NSFR is designed to incentivize banks to seek more stable sources of funding over the medium to long term. **To secure financing for longer-term assets, banks will be required to issue longer term debt. For the market to come into equilibrium it is vital that this longer-term debt be provided by investors.** The market will be further affected by bail-in proposals that could impact holders of senior debt during a bank resolution. This will limit the willingness of many investors to take on this exposure, as well as leading to higher funding costs.

The proposed Volcker Rule, depending on its final form, could have negative effects on market making and reduce liquidity for many securities. As a consequence of this, combined with the proposed exclusion of bank debt for liquidity purposes, investors might be reluctant to invest in certain securities if demonstrable market liquidity is lacking.

Banks regularly provide derivatives for risk management purposes to end-users, managing their own risk via warehousing, managing and hedging resultant positions. Insofar as banks depend on investors and other market participants to provide them with the other side of their risk positions, **any change in derivatives regulation that limits investors' participation in the market could diminish the ability of banks to provide hedging opportunities to end-users.** Further, and against this backdrop, the proposed Volcker Rule could force banks to find positions on a more matched and timely basis, and reduce risk warehousing activity. Banks will increasingly need to find offsetting transactions to service customer risk management needs at a time when other reforms are making that task more difficult, with a consequent negative impact on end-users.

More broadly, new OTC derivatives rules focus on central clearing as a means of controlling credit risk and increasing transparency. **Counterparties to non-cleared trades—including many investors—will be subject to much higher collateral and capital requirements.**

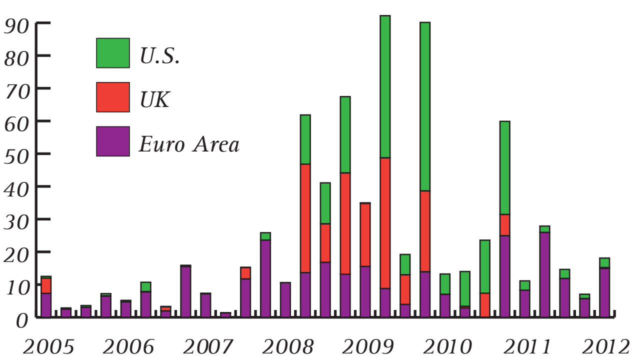
THE AVAILABLE EVIDENCE

Since the beginning of the financial crisis, banks have issued over $600 billion in new equity (Chart 40). This significant amount has been taken up by investors but at a cost—the book value of bank equity has declined markedly during this time (Chart 41). Investors have thus seen a significant dilution of their holdings.

Chart 40

U.S., UK and Euro Area Bank Equity Issuance

$ billion

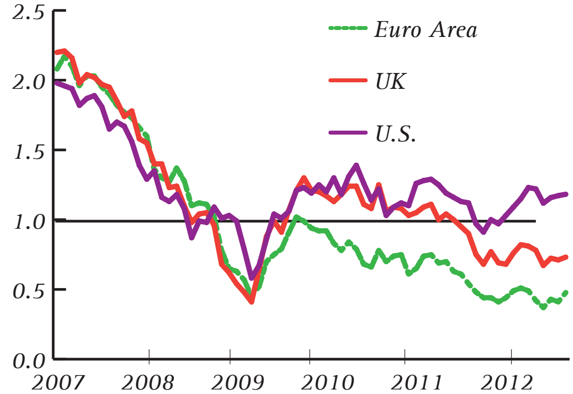


Source: Thomson

Chart 41

U.S., UK and Euro Area Banks Price-to-Book Ratio

MSCI Indices



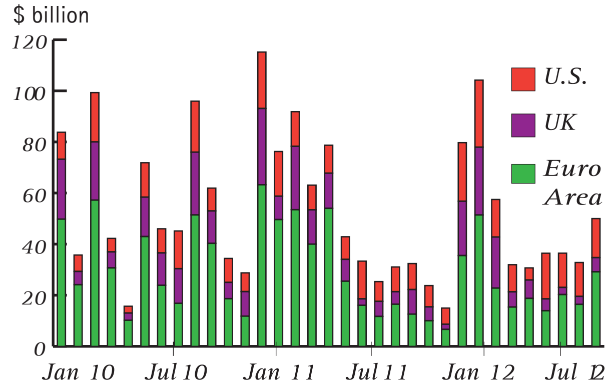
Source: MSCI

Bank bond issuance, while generally supported by the low interest rate environment and generous central bank liquidity provision, is well below pre-crisis levels (Chart 42). Unsecured debt issuance in particular has weakened, with banks relying more heavily on collateralized forms of financing such as covered bonds. Moreover, investors appear to be less willing in many cases to provide longer-term financing: the average duration of bank debt has decreased significantly for UK and continental European issuers over the past several years (Chart 43).

Chart 42

U.S., UK and Euro Area Bank Bond Issuance

$ billion

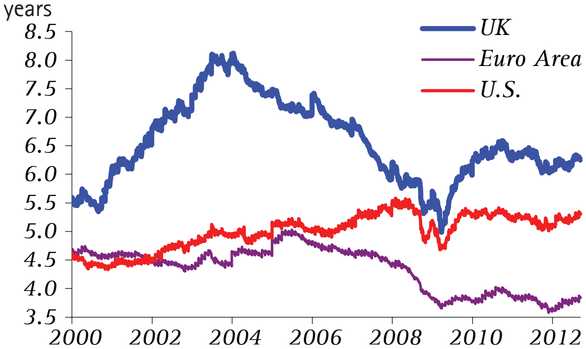


Source: Thomson

Chart 43

Duration of UK, U.S. and European Bank Debt

years



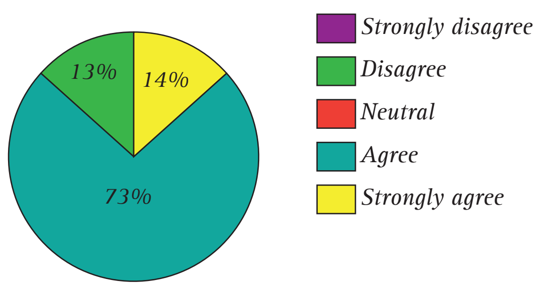
Source: Thomson

THE EVIDENCE FROM QUESTIONNAIRES

Two-thirds of investors surveyed believe that the reform agenda does not strike the right balance between resilience in the financial sector and maintaining efficiency in the provision of financial services. **Nearly 75% of respondents believe that regulatory uncertainty is contributing to current (low) bank valuations.** Two-thirds of respondents believe that the regulatory agenda will lead to lower investor holdings of bank equity and over 90% believe that it will lead to lower holdings of long-term bank debt. Nearly two-thirds of respondents believe that the combination of liquidity and margining reforms in OTC derivatives markets will require significantly higher returns and/or heavily restrict investment. Finally, some 60% of respondents believe that **as a result of regulatory changes, investors will have increased safety, but with a downward shift in returns.**

Chart 44

Current bank equity valuations reflect, in part, the expected or uncertain impact of regulatory change on banking business models.

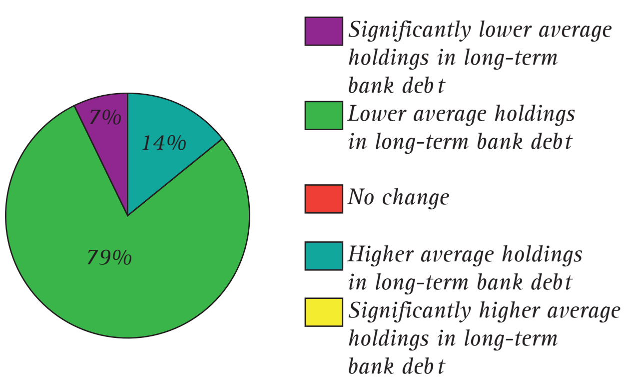


Respondents: 15

Source: IIF

Chart 45

There will be a secular shift in holdings of institutional investors in long-term bank debt (>1 year maturity) as a direct result of the regulatory agenda as follows:



Respondents: 14

Source: IIF

Some of the comments received were:

"The post-crisis reform agenda in the financial sector industry, while needed and well-intended, adds to the market uncertainty. Some of the reform efforts are unclear, uncoordinated across national jurisdictions and indifferent to the financial sector participant's underlying risk characteristic. Also, the provision of "zero-risk" weights for sovereign bonds in the regulatory risk capital is hardly conducive for market stability"

"The pendulum has swung too far, and the costs being imposed are impeding efficiency."

"Bail-in legislation is likely to negatively affect demand for long-term bank debt, except for debt issued by the strongest financial institutions."

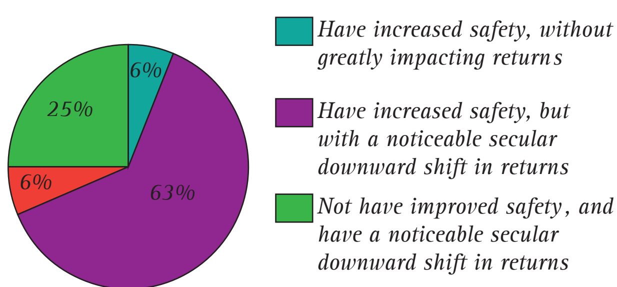
"Banks will be less profitable under the new regulatory structures. Bail-in and other resolution schemes will cause investors to move up in capital structure while reducing duration."

"The regulatory changes underway in the bank sector risks unsettling the seniority of bank debt. It could take time for the risk premia of bank debt to adjust and in this adjustment process, the institutional investor holding in bank debt is likely to be lower than previously."

"If objectives are accomplished, safety of the system will be improved. However, it is not clear if the implementation will accomplish this objective."

Chart 46

As a result of the overall financial system regulatory change agenda, the end-investor will:



Respondents: 14

Source: IIF

CONCLUSION

THIS REPORT REPRESENTS A PRELIMINARY ATTEMPT TO EXAMINE SOME OF THE POTENTIAL UNINTENDED CONSEQUENCES FOR END-USERS OF THE REGULATORY REFORMS THAT HAVE BEEN OR ARE BEING ADOPTED IN RESPONSE TO THE FINANCIAL CRISIS. IT REPRESENTS A STARTING POINT FOR DISCUSSION RATHER THAN AN END OF THE DEBATE.

Nevertheless, what is clear from the analysis, data and responses to the surveys is that there will likely be significant impacts on end-users of all sizes and that these impacts have so far not been fully assessed.

There are already some observable impacts that are worth noting, particularly on many SMEs that are seeing costs increased and access to credit reduced. This is of major concern given the importance of such firms for the fragile economic recovery and for the livelihoods of millions of employees. Moreover, bank funding has become much more difficult and expensive, at least partly due to the regulatory uncertainty that banks face.

This impact is likely to be stronger once the full shape and content of financial reforms have materialized. Banks that have so far absorbed the costs of existing reforms are then likely to pass them on or withdraw from business lines altogether if adequate returns cannot be achieved. It is urgent and essential that these impacts are more completely understood and any unintended negative effects mitigated.

The IIF is committed to playing a full role in this and recognizes that the necessary study can only be successfully carried out if conducted in partnership with the policy making community, the regulatory community, the academic community and most importantly with end-users themselves. To that end, the IIF suggests three courses of action:

i. Engagement and constructive dialogue with partners;

ii. Comprehensive analysis of the impacts; and

iii. Action to mitigate unintended effects.

In the coming months, the IIF will be reaching out to the international policy community and in particular to the Financial Stability Board, International Monetary Fund and Organization for Economic Cooperation and Development to engage with them on understanding and mitigating these impacts. We will be reaching out to the academic community to encourage analysis and develop a more evidence-based approach. Above all, we will be engaging with end-users, be they representatives of consumers, SMEs or large corporates, on the impacts that we have identified. We will look to do these both bilaterally and through conferences and roundtables to examine the issues.

The aim of this engagement will be to provide stimulus to the policy making community, academic community and end-users to carry out further study and analysis of the impacts both positive and negative. Over the coming period, the IIF itself will be deepening and extending the preliminary analysis in this Initial Report. In the same way as for the analysis of the net cumulative economic impact of reform, the more analysis that is performed, the better.

But once this engagement and analysis has taken place, it is vital that the results then lead to action that preserves beneficial impacts but mitigates detrimental effects. Such action might include three forms:

i. More gradual phasing-in of reforms;

ii. A revised calibration of some of the reforms being put in place; and

iii. A more effective coordination of reforms both across jurisdictions and across the reforms themselves, to ensure that reforms in one area or jurisdiction do not simply transfer the risks to another.

The issues outlined in the above report are complex ones, and they are all the more difficult to understand given the tremendous changes taking place within the world economy and financial system. Nevertheless, it is essential for sustainable economic growth that they are understood and that appropriate action is taken. The IIF looks forward to being a constructive partner in this endeavor.

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