BUSINESSEUROPE

SPEAKING POINTS

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PANEL II – NEW BASEL FRAMEWORK – THE RIGHT BALANCE?
TUESDAY 16 NOVEMBER – 12.00 HOURS

What are the facts:

A. The Economic Situation has improved

- The second part of the year has so far brought relatively **good news for the European economy**. Growth has been stronger than expected and domestic demand is gradually strengthening. In this context, we foresee that growth in the EU could reach up to 2% this year.

- The stress tests that were carried out earlier this year also showed limited **risks of immediate instability** in the European banking sector, and interest rates **remain low in** most parts of the EU.

B. Banks are not willing / able to extend lending to companies

- But **access to finance remains a major concern** for the sustainability of this upturn, especially now that companies will need to gear up for **new investments**.

- Lending to **corporations is still registering negative growth rates** (in euro area, down 0.6% in September 2010 compared with September 2009). Overall, banks reported a new net tightening of credit standards during the third quarter of 2010. **By contrast**, household lending is again growing at healthy rate (in euro area, 2.8% year-on-year in September), and **loans to government** were **growing at record levels** (in euro area, 7.1% year on year in September). This may indicate that **risk appetite for corporate loans is very limited among banks** at the moment, and that large **public financing needs are already crowding out capital availability** for companies.

- This feedback loop is **especially intense in Europe, where companies depend highly on bank intermediation** for their access to finance. As demand for capital intensifies, companies will find it increasingly difficult to obtain credit, especially if

securitisation markets remain dysfunctional, hindering banks' ability to free up capital for new lending.

C. **The sovereign debt crisis is having an impact on companies' finance**

- We have clearly observed during the Greek debt crisis saga this Spring a significant tightening of credit conditions, **as banks have found it increasingly difficult to access wholesale funding and liquidity.** This is affecting companies' financing conditions throughout the value chain, and SMEs in particular.

What should we learn from this:

- There is an immediate and tight link between the health of public finances, financial sector balance sheets and investment conditions for companies.

- So, **although economic conditions have clearly improved in recent months, a protracted credit squeeze** remains a very tangible risk for this recovery in 2011 and beyond.

What are the challenges ahead:

- In this regard, we think four issues are of fundamental importance looking forward:

  1) Timing and conditions of the exit from exceptional support measures in the financial sector;
  2) Necessary drive for smart consolidation strategies in the public sector;
  3) Balanced agenda of financial markets reforms;
  4) And development of alternative sources of financing for companies.

Let me illustrate the issue of a balanced agenda of financial markets reforms:

1) Financial Market Reform

- **BUSINESSEUROPE supports regulatory initiatives** that resolve the regulatory failures that led to the financial crisis. We think in particular that the reform of European financial supervision agreed by the Parliament and Council is a very significant step forward.

- But to regain confidence, **reforms must strike the right balance** and be mindful of their consequences for non-financial companies.

- **Basel III** is a case in point. Tighter capital rules for banks are clearly needed but this will obviously **lead more restrictive lending conditions** for companies and greater reliance on market financing.

- We think it was right to propose transitional arrangements for implementing the new Basel III standards**.**

- However, we are still concerned about certain aspects of the proposals.

- For example, **new liquidity requirements** that could create an additional bias in favour government debt as opposed to private sector securities, which is considered more risky.

- This will interact with other **prudential rules**, **such as those linked to Solvency II, which also discourage investment in riskier assets such as equity and favours government debt.**

- Another example is the rules' **treatment of trade finance**. If banks would be forced to hold five times more capital to back trade finance business this would severely **hamper world trade**.

- Another example are **leverage ratios that take no account of the risk profile of a loan** leading to low-risk loans unfairly driving leverage ratios beyond maximum thresholds which reduces lending.

- New accounting rules will also impact on capital allocation such as requirements to bring securitised loans on to banks' books and rules related to the way financial institutions account for bad loans.

- Recently, the **Commission also presented proposals to increase transparency and resilience of derivative markets**. The **purpose** is to increase transparency to detect risks to financial stability, and **reduce the risk exposure that banks have with each other** through derivatives contracts.

- **BUSINESSEUROPE supports this**, and is pleased that **exemptions are provided for contracts that are used to hedge commercial risk,** subject to certain limits because proper risk management is vital for the credit rating of companies which determines the cost of liquidity and financing.

- However, there is also the issue of **non-standardised derivative contracts** – the so-called 'tailor-made' hedging contracts that are sometimes necessary to manage particular risks but which cannot be cleared. It is **unclear how much capital or collateral Basel III will require banks to hold for these contracts** and consequently how much more expensive these contracts will become.

- **Smart regulation must ensure that the right solutions are found and that policies are effective and proportionate in their scope and nature**. **Comprehensive impact assessments** must therefore be carried out which address the **cumulative impact of different reform measures**.

- Lastly, there is also the issue of **consistent application at global level**. We expect the G20 to strengthen the resilience of global financial markets through close coordination. This should include efforts to avoid divergent policies. So G20 countries should **work cooperatively on the implementation and further calibration of new capital rules** – especially across the Atlantic – to ensure that access to finance and the competitiveness of European companies will not be unduly affected.