Biting the Basel III bullet

WITH THE NEW REGIME ALREADY STARTING TO AFFECT THE REAL ECONOMY, **GRAHAM BUCK** HEARS WHAT OPTIONS ARE OPEN TO TREASURERS IN RESPONDING TO THE REGULATION.

It is a testament to treasurers' concerns about how widely the ripples caused by Europe's new raft of financial regulation will extend that an ACT breakfast briefing on the topic in November attracted a large crowd. The event, sponsored by Lloyds Bank Corporate Markets, was entitled "Basel III for treasurers – are the mists clearing?" The session provided much evidence that the answer is still far from affirmative.

Chris Bates, a partner at law firm Clifford Chance, said the recent extension of capital requirements to all parts of the financial services sector, including the Solvency II regime for the insurance industry, was likely to continue. Bank creditors have woken up to the fact that their assets are more at risk than they imagined, and this had been reflected in banks' increased funding costs. "So Basel III is not the end of the story, but rather the beginning," said Bates.

He noted that the EU's Capital Requirements Directive had undergone a number of revisions since its adoption in 2006, with the fourth round of amendments, CRD IV, appearing only last July.

While the intention is for the tougher new capital requirements for banks to be phased in steadily, commencing in 2013 and continuing up to 2019, most of the major banks have indicated that they intend to meet the new rules well before the deadline takes effect.

Risk weighting, one of the first measures introduced, requires banks to take on much more capital for any type of derivatives exposure, meaning increased charges for over-the-counter (OTC) derivatives.

Two new liquidity requirements, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), are due to come into force from 1 January 2015 and 1 January 2018 respectively. LCR, applying to cash outflows under stress, incorporates a definition of what "stress" means, including a partial loss of ratings by a bank. NSFR, also referred to as the "Northern Rock ratio", aims to prevent a mismatch between a bank's funding and its assets.

The impacts of these new requirements will be felt in:

- the cost and availability of corporate credit;
- competition for the banks themselves in the capital markets from term funds (although LCR/NSFR favours bank holdings of corporate bonds);
- the cost and availability of OTC derivatives;
- cash management; and
- structural issues, if some entities are judged financial.

DELEVERAGING Johann Kruger, head of accounting and regulatory advisory at Lloyds Bank Corporate Markets, told the meeting that banks had a range of options in boosting capital and liquidity to meet the Basel III rules. Options included selling down risky assets, raising equity, reducing costs, and realigning (and ultimately shrinking) the balance sheet. The final option was often the only viable choice resulting from a combination of higher capital requirements, an inability to raise equity and thin margins even after cost efficiencies.

As an example of what might be coming, in November UBS's incoming CEO Sergio Ermotti quickly set out plans to reduce the bank's balance sheet by half, while Morgan Stanley's Huw van Steenis predicted a total balance sheet deleveraging of €1.5–2.5 trillion over the next 18 months.

What sort of effect do experts perceive this as having over the next few years? Kruger cited the Institute of International Finance's recent forecast that a massive $1.3 trillion additional core Tier 1 capital will be needed by 2015. The IIF expects this burden to shave 3.2% off world gross domestic product (GDP) by 2015 and add up to 360bp to lending rates over the next five years.

Households, small and medium-sized enterprises (SMEs) and international trade finance will feel the effects. "It means effective monetary tightening when we need the opposite," said Kruger. However, the impact will potentially be heavier in Europe than in the US, where only around 30% of all corporate funding is provided by banks and the remaining 70% comes from the capital markets.

One unintended consequence of the new requirements in Europe would be that corporate treasurers cease to hedge, or make greater use of natural hedges and purchased options. Other actions open to them include greater use of purchased options, caps, "swaptions" and limited liability swaps, pay-as-you-go structures such as inflation swaps, and credit breaks. Other courses of action include doing as much hedging as possible while the market is behind the curve and, if all else fails, to collateralise or clear centrally if possible.

COMPLIANCE SLEDGEHAMMER An account of the conditions that many European treasurers are already experiencing was provided by Mark Morris, group treasurer at Rolls-Royce. "The group relies on financial instruments for planning and derisking our business, so along with many other non-financial companies we will be affected by the raft of new financial regulations," he said. "While intended to make the system safer, they will have an impact on the real economy. The desire to derisk everything overlooks the fact that retaining a degree of risk is actually healthy for business."

Morris said the combination of global markets and national/regional regulators created a lack of trust between regulators and market participants. This in turn increased the risks of overregulation, damaging regulation that eroded growth, and fear created by uncertainty. "Gold-plated regulation runs the risk of killing off markets," he suggested.

He viewed three EU financial directives as key for treasurers:

- CRD IV (fourth Capital Requirements Directive), which addresses bank capital, leverage and liquidity;
- EMIR (European Market Infrastructure Regulation), which covers the reporting and clearing of OTC derivatives; and
- MiFID (Markets in Financial Instruments Directive), which deals with trading and standardisation of financial instruments.

"We need to respond to this legislation by becoming better organised and lobbying," said Morris. "We have a voice which needs to be heard."

CRD IV would directly increase loan costs and restrict loan access. Companies would respond by lessening their reliance on banks as the focus shifted to the capital markets, but this would not prevent higher costs for end users, both wholesale and retail.

Morris said ratings agency Standard & Poor's had estimated the incremental borrowing costs resulting from the new requirements in a report issued in September, called "Why Basel III and Solvency II will hurt corporate borrowing in Europe more than in the US".

Rolls-Royce was already seeing the impact, Morris added, as a number of its suppliers were struggling and the banks were doing nothing to help them.

In a panel discussion that concluded the session, the speakers were joined by Tim Hayter, group treasurer for outsourcing and distribution group Bunzl. He supported the recommendation that treasurers diversify their funding sources as much as possible, adding that Bunzl had already tapped the US private placement market.

"We've widened the geographical spread of the banks we use, diversified by currency and refinanced existing loans," he said. "We've also diversified by amount, decreasing our credit facilities with the major banks and increasing them with smaller ones. Banks generally are becoming more difficult to read, hence the greater diversity. We've used bilateral rather than syndicated loans to achieve this, together with interest rate and currency swaps to access the US market."

DELIBERATE DISHONESTY Panel members were asked by John Grout, the ACT's policy and technical director, what their response was to recent comments by Robert Jenkins, an independent member of the Bank of England's Financial Policy Committee. Jenkins had accused the banking industry of deliberate dishonesty in exaggerating the negative effects of the new regulations and their impact on the flow of credit to business.

Bates responded that, given the huge changes imposed by the new regime, it was little surprise that the banks had reacted so sharply. But in the main changes had been accepted and debate was mainly limited to modifications being made "on the margins".

Morris added that while there was general acceptance that the system had to be changed, much of the regulation ranged from the "mildly irritating" to the potentially damaging. There was also great concern that the existing correlation between various pieces of the new legislation was not properly understood.

A final question for the panel was whether companies should borrow now, even if they had no immediate need for funding, as borrowing was about to become dearer and more restrictive.

"There is undoubtedly a strong case in favour of prefunding, but much depends on your business's individual needs and any possible reaction in the share price," said Kruger.

Morris said that recent evidence of a lessening reliance on banks and a greater focus on the capital markets would continue. "The markets have a habit of innovating, though, so I'm not convinced by the case for borrowing now rather than later," he concluded.

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Shedding further light

The continuing uncertainties over Basel III have been acknowledged by the Basel Committee on Banking Supervision, which in December published a new set of answers to some frequently asked questions about the new regime.

The latest interpretations focus on the Basel III regulatory frameworks for capital and liquidity, published in December 2010, and the press release of 13 January 2011 on the loss absorbency of capital at the point of non-viability. They also update the second set of FAQs relating to the definition of capital that the Basel Committee, which provides a forum for regular cooperation on banking supervisory issues, issued last October. The answers can be accessed at **http://bit.ly/vZuqKa**