THE EVOLVING FINANCIAL LANDSCAPE

HOW IS 2014 LIKELY TO LOOK FROM AN ECONOMIC, POLITICAL AND REGULATORY PERSPECTIVE? MAURICE CLEAVES PAINTS A PICTURE OF THE COMING YEAR

Now that we've reached November, the European business community is inevitably starting to look ahead to 2014. What can we expect from the coming year? Will the fragile economic growth that appears to be under way in the developed nations gather further momentum or will it suddenly derail? How will the financial markets react when the US Federal Reserve finally starts to taper off its quantitative easing (QE) programme? Will the eurozone crisis flare up again or will it be consigned to the history books once and for all? How will ever-stricter regulation change the business landscape for corporates? These are all questions that will concern corporate treasurers and for which there is no obvious answer.

Economic growth

Fortunately, strengthening financial conditions do suggest that we should see greater international economic activity over the next few quarters. At Barclays, we are optimistic and are forecasting 4% global growth in 2014 (climbing to 6% in the emerging markets). The International Monetary Fund (IMF) is also positive about the direction in which we are heading, forecasting international growth of 3.6% next year in its *World Economic Outlook*, published last month. Output in the US, which is driving much of the global recovery, should increase further next year provided politics does not get in the way, according to the IMF. Corporate growth within the world's largest economy is partly related to the significant private-sector deleveraging that has taken place since 2008.

Nevertheless, stagnant global industrial production (for example, in the auto, IT and steel industries) could be an obstacle to growth, particularly since we are living in an unusual environment, characterised by very low interest rates, a continued trend of debt aversion and high inflation. There is also the challenge presented by economic slowdown in the emerging markets, which have been the engine room of the global economy for some time. The IMF has warned that growth in China, in particular, will slow over the medium term as the country's economy transitions away from being investment-driven to being consumption-driven. Also, the imminent end of ultra-loose US monetary policy and the tapering off of QE is likely to result in further volatility in the financial markets, at least in the short term.

Eurozone

While the European Central Bank's outright monetary transactions programme has eased financial conditions in the eurozone, significant structural issues continue to trouble the region. The peripheral nations remain uncompetitive compared with Germany and unemployment continues to blight recovery. Figures released last month by Eurostat, the EU's statistics office, revealed that unemployment stood at 12% across the eurozone in August. In Greece, unemployment soared to 27.9% in June (reaching a staggering 61.5% among the youth population), while it was 26.2% in Spain. Even France, which is regarded as a 'core' eurozone country, notched up 27 successive months of rising unemployment until July 2013, registering a fall for the first time in August. Large-scale unemployment in the eurozone is unsustainable and will need to be resolved. Whether this happens in an orderly or disorderly way remains to be seen, however. There seems to be some way to go before we will see stable growth return to the eurozone.

CRD IV

For corporate treasurers, the impact of regulation on the financial services sector will be a concern throughout 2014. Capital Requirements Directive IV (CRD IV) – the package of reforms that will implement the Basel III agreement on capital adequacy in Europe – enters into force on 1 January 2014, although some of the provisions will be phased in between 2014 and 2019. The reforms aim to improve the banking sector's ability to withstand financial shocks, improve risk management and governance, and strengthen banks' transparency and disclosures. Under the new rules, banks will have to hold more, better-quality capital

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and build up capital buffers as a further cushion against losses. They will need to manage their cash flow to ensure that they have reliable liquidity available in both the short term and longer term. And they will have to abide by leverage limits regarding the volume of assets they can acquire compared with the capital they hold. If they trade in complex financial products such as derivatives, they will have to hold further capital still.

Banks are reviewing their client portfolios to ensure that they comply with the risk ratios specified by CRD IV and they are trying to manage their exposure effectively. They are also looking closely at the return on capital of the products that they offer and the risks that those products present. Without doubt, the portfolio nature of banks' business models will become far more important than it used to be as banks work out the balance of assets and liabilities that they want to hold across their client base.

Ultimately, banks could be forced to make some difficult choices about the markets they enter, the clients they serve and the product mix that they provide. In other words, local, regional banks may decide not to expand beyond their current footprint and global banks may choose not to provide certain products to certain clients in certain locations. Neither of these developments will be welcomed by corporates, which naturally favour healthy competition in the banking market. To make matters worse, the capital and liquidity ratios of CRD IV are effectively raising the barriers that potential new entrants to the banking sector must overcome, further decreasing the potential for greater competition.

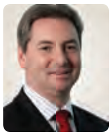
While the banking environment for corporates is unlikely to change overnight, there will undoubtedly be some significant changes over the longer term, not least in terms of the pricing of financial products and services. Complying with regulation places a heavy financial burden on banks, a burden that will inevitably be passed on to their clients to some degree. The good news is that regulatory change is prompting banks to be more innovative, however. They are investing in activities such as mobile banking and trade finance, where they can provide a service that clients want while enhancing their own revenues.

Economic, political and regulatory forces will undoubtedly shape the financial landscape in 2014 and the future remains uncertain despite a tentative return to growth within the developed markets. But corporates that have a close partnership with their banks will find it easier to overcome the hurdles that await them over the coming year. As American footballer Walter Payton once put it: "We are stronger together than we are alone."

TSUNAMI OF REGULATION

CRD IV is just one very significant wave in the tsunami of regulation sweeping over the financial sector. Other reforms include:

- **An obligation for companies that use OTC derivatives to report their trades to trade repositories from February 2014. This is to comply with the European Market Infrastructure Regulation.**
- **An EU proposal to impose capital rules on money market funds (MMFs) to counter the risk of an investor run on the funds. Constant net asset value MMFs (those with a fixed share price) would be forced to build up a cash buffer that is equivalent to 3% of their assets. The new rules will prevent banks from supporting any MMFs that they control, which could be problematic since the Federal Bank of New York estimates that banks control around 40% of the MMF industry. It is also proposed that MMFs should be banned from getting a credit rating to remove the risk that a downgrade triggers a run. In the US, the Securities and Exchange Commission is also trying to tighten the rules on MMFs.**
- **Eleven eurozone nations are still planning to implement the controversial financial transaction tax on transactions, including trading in shares, bonds and derivatives, although it seems unlikely that this levy will take effect in 2014 as originally planned.**
- **The Foreign Tax Compliance Act, which is intended to combat tax avoidance by US citizens, imposes a significant reporting burden on so-called foreign financial institutions from July 2014. Non-financial companies may also find themselves caught in the net if they make cross-border payments.**



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