



31 March 2011

GLOBAL IMPACT OF BASEL III AND SOLVENCY II ON THE FINANCING OF ENTERPRISES

Executive Summary

Financial reform, financial stability and access to finance

- Considering the fundamental importance of financial stability for the economy, BUSINESSEUROPE supports reinforcing (for banks) and modernising (for insurance companies) prudential rules. The efficiency of these reforms depends on the existence of a global level playing field which takes account of European specificities regarding access to finance and bank lending to avoid regulatory arbitrage and any distortion of competition.
- The new rules will have a significant impact on the financing of the European economy and in particular on the financing of smaller and medium-sized European companies. This will be even more serious considering the cumulative effects of the different prudential rules combined with other financial reform measures.

Basel III and Solvency II

- New requirements will lead to tighter and costlier access to bank lending and will discourage institutional long-term investments.
- Both Basel III and Solvency II will lead to an increase in demand for long-term government bonds to the detriment of corporate financing.
- Basel III will hamper trade and harm the competitiveness of European enterprises through tighter and costlier access to export finance and trade finance instruments.

Cumulative Impact

- A number of other legislative projects, both recently adopted and planned, will also have an impact on financing conditions, such as rules on private equity, derivatives, measures to reinforce bank depositors' protection, financial sector tax and resolution schemes. The combined effects of these reform measures together with new prudential rules should not jeopardise European companies' access to finances.
- At a time when the economic recovery can only be sustained through an increase in corporate investment, it is essential that the uncertainty with respect to access to finance and economic growth is resolved.
- BUSINESSEUROPE therefore underlines the importance of a comprehensive quantitative impact study on the cumulative effects of both Basel III and Solvency II, within the larger framework of all the new financial reform measures, which assesses both macroeconomic effects and the consequences for the financing of European companies.
- In addition, comprehensive *ex-post* evaluation of reform measures is essential to identify subsequent harmful effects and allow necessary adjustments.



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INTRODUCTION

Financial market stability is fundamental for the economy and European companies. BUSINESSEUROPE therefore supports the actions of international and European regulators aimed at reinforcing (for banks) and modernising (for insurance companies) prudential rules. The efficiency of these reforms depends on the existence of a global level playing field which takes account of European specificities regarding access to finance and bank lending to avoid regulatory arbitrage and any distortion of competition.

The new rules will have a significant impact on the financing of the European economy and in particular on the financing of smaller and medium-sized European companies. This will be even more serious considering the cumulative effects of the different prudential rules combined with other financial reform measures.

- The new requirements will imply tighter and costlier access to bank lending and will discourage institutional long-term investments which will strongly affect the corporate sector.
- Basel III will hamper trade and harm the competitiveness of European enterprises through tighter and costlier access to export finance and trade finance instruments.
- Both Basel III and Solvency II will lead to an increase in demand for long-term government bonds to the detriment, again, of corporate financing.
- The application of the new prudential ratios of Basel III and Solvency II would lead to an increase of equity needs in the financial sector which could no longer be covered by insurance companies, traditional institutional investors, affecting also competing financing needs of other companies.
- Further measures contemplated by the Financial Stability Board such as imposing a capital surcharge to so called Systemically Important Financial Institutions (SIFIs), will contribute further to these effects.

We are worried that liquidity ratios that are currently debated will limit to a large extent the transformation of short term savings into long term financing products which is an essential function of European banks. Liquidity management should ultimately not seek the end of the transformation role of banks but avoid the risks of excess transformation. Liquidity management should therefore preferably take the form of a tailored management tool rather than the form of a binary regulatory instrument. Also, the new liquidity ratios will encourage the re-intermediation of money market funds' assets through a "race for deposits" instead of the issuance of certificates of deposit. As a result, such re-intermediation would probably imply a slightly higher percentage ratio



but the overall economic outcome is not clearly positive (for either banks or investors that seek risk and credit diversification). The destructive side effect on money market funds will affect their ability to continue fulfilling their economic role in the financing of the economy.

At a time when the economic recovery can only be sustained through an increase in corporate investment, the implementation of reform measures could create an overall shortage of companies' main sources of financing. This uncertainty should be resolved and BUSINESSEUROPE therefore underlines the importance of a comprehensive quantitative impact study on the cumulative effects of both Basel III and Solvency II which assesses both macroeconomic effects and the consequences on the financing of European companies.

A number of other legislative projects, both recently adopted and planned, will also have an impact on financing conditions, such as rules on private equity, derivatives, measures to reinforce bank depositors' protection, financial sector tax and resolution schemes. The combined effects of these reform measures together with new prudential rules should not jeopardise European companies' access to financial markets on competitive conditions and their ability to find long-term investors, especially for SMEs.

I. MACROECONOMIC IMPACT AND CONSEQUENCES OF THE REFORMS

1.1 Difficulty to measure the real impacts

- ***Contradictory quantitative impact studies on Basel III***

Since last summer, some studies on the macroeconomic impact of Basel III have been carried out, such as by the Institute of International Finance (the IIF) and the Basel Committee on Banking Supervision. Depending on the studies, which are based on different sets of assumptions, the global cost of the new banking regulation may naturally vary. However, in all cases the cost appears to be non-negligible.

IMPACT ON GROWTH

The Institute of International Finance (IIF) has estimated that the Basel III requirements could impact G3 countries (Japan, U.S, Euro Area) growth by as much as minus 3% in 4 years and even minus 4.5% in the euro area.

In parallel, the Basel committee displays a lower impact: a 1 percentage point increase in the target capital ratio of Tangible Common Equity to risk-weighted assets may lead to a decline in the level of GDP of 0.2% 4 years after the implementation. However, looking at their most recent study, it appears that the impact on this ratio may exceed 5 percentage points for large and stable banks.

The impact is thus also significant in the Bank for International Settlements (BIS) study. It should be noted moreover that the economic impact of the implementation of the liquidity measures, which should drive to larger shortfalls, is not even included. A 2010



Committee of European Banking Supervisors (CEBS) impact analysis identified shortfalls of €291 billion, €1 trillion and €1.8 trillion respectively.

Basel III will thus cause significant capital and liquidity shortfalls for banks: likely for 2019 €602 billion on capital, €1.7 trillion (the equivalent of 14% of the European 2010 GDP) on liquid assets (LCR1) and €2.9 trillion (the equivalent of 24% of the European 2010 GDP) on stable funding (NSFR2) (BCBS-December 2010).

It will thus lead to a massive transformation of the banking industry. During the transition period, banks will have the possibility to get closer to the requirements by retaining earnings and issuing equity. However, as banks will not be able to raise the all the necessary funding to meet Basel III liquidity requirements, they will have to restrain their lending activities and/or increase their lending costs. The impact is therefore expected to be substantial.

▪ ***Absence of pertinent global quantitative impact study on Solvency II***

In comparison with the new banking reform, to this day, there is no macroeconomic impact study for Solvency II. We understand that an impact study was conducted by the European Commission in 2007 but the financial turmoil that occurred since has made these results obsolete and there is a need for an up-date in the light of current market conditions.

The European Commission has proposed to test the proposals that are put forward in the implementing measures of the Solvency II directive through a quantitative impact study on the concerned entities, the fifth of its kind since the beginning of negotiations (QIS 5). Initial results indicate that these proposals go beyond the framework of Solvency II that had established the risk level underlying the evaluation of insurance companies' capital.

If these orientations are adopted, European insurers would have to review their risk-taking strategy. This would be to the detriment of the policyholders, the economy and the European insurance industry.

▪ ***The lack of European impact study on cumulative impact of the reforms***

The cumulative impact of the implementation of the macro-prudential reforms on the European economy and on the financing of European enterprises would be strong, probably much more significant. A macroeconomic impact study on the combined effects of Basel III and Solvency II, within the larger framework of all the new financial reform measures is therefore urgent and essential.

¹ The Liquidity Coverage Ratio (LCR) is:

$LCR = (\text{Stock of high quality liquid assets}) / (\text{Net cash outflows over 30-day time period})$

LCR must be greater than or equal to 100%

² The Net Stable Funding Ratio (NSFR) is:

$NSFR = (\text{Available stable funding}) / (\text{Required amount of stable funding})$



1.2 Inevitable consequences

- ***The current model of transformation of short savings in long term financing products will be questioned***

In Q2.2010, the financial & monetary institutions of the euro area have created about €10,500 billion of long-term resources in the economy. Per year, about €500 billion short-term savings are transformed by these institutions into long-term financing. The new requirements on banks and insurance companies' capital will alter their business model and will impact significantly on their economic role of providing long-term financing.

- ***For the non-financial corporate sector, more difficulties to access financing, especially for SMEs***

Banks and insurers are two key providers of business financing in Europe. With the new Basel III requirements and through the orientation that has been given to the Solvency II 'implementing' measures, their role is being called into question.

- ***For trade finance and export credits***

Trade finance, export credits and specialised lending will be adversely affected by the new Basel III rules. Partnerships between the private and the public sectors will be lost while governments need to reduce their budget deficits.

Export finance is a segment where the public sector traditionally aims at complementing the private market. The increased cost of lending combined with possible changes in risk-weighting of publicly-owned export credit agencies (ECAs) will make export finance less attractive for the financial sector. Many EU countries are dependent on the private financial sector for providing loans and only offer risk insurance through their ECAs. With the envisaged changes in the Basel III, this may have to change, thus increasing public activity in direct lending. Furthermore, this change in balance between private and public participation will also be affected by whether the country in question has access to instruments that transfer medium and long-term loans to liquid assets

Trade finance is in fact touched by several elements: First, as lending between banks are an essential element of trade finance, the increase of risk weight for financial institutions of 20 – 30 % will increase the lending costs. Second, as trade credit has no bonus in Basel III, the capital ratio requirement will increase up to fivefold. Finally, the new liquidity rules ask for reserves for off-balance-sheet lines like the one for letter of credits. The total additional costs (i.e. higher interest) are calculated of about 100bp.

Trade finance support and export credit are vital for importers and exporters, and above all SMEs, to finance their implantation and development in emerging markets. While increasing the cost and/or reducing the availability of such financial instruments, Basel III prudential rules will reduce dramatically the liquidity capacities of European companies for trading and investing and leave such markets to their competitors that use other financial supports.



The official supported export credits are long-term credits insured and guaranteed by National Export Credit Agencies that are mainly state-owned companies or acting on behalf of States. They are mostly recognised as being of a low risk nature and under the current Basel II rules, their exposures are assimilated on the corresponding ECA sovereign risks. For those reasons, such instruments should be recognised within Basel III standards as a high quality asset both regarding its treatment under the leverage ratio and the two new liquidity constraints (Liquidity Cover Ratio and Net Stable Funding Ratio).

Regarding trade finance and short-term trade, a recent survey from the International Chamber of Commerce and the Asian Development Bank, "Trade Finance Default Register study", stresses that during the last five years (including the period of the financial crisis), the 5.2 million trade finance transactions studied had low default rates and in the very rare occasions of loans defaults, loss recoveries were high. Thus, current Basel II provisions relating to trade finance have not been demonstrated as "inadequate and inefficient". If there is no tangible evidence to change these current standards, our simulations show that the Basel III proposals would significantly increase the cost of credit and reduce its availability.

FINANCING OF COMPANIES IN EUROPE: THE IMPORTANCE OF BANKS AND INSURERS

In the Euro zone, the corporate sector is highly dependent on bank lending. Indeed, in the US, the share in the financing of the non-financial corporate sector (in Q3.2009) is just above 25% of debt finance, and less than 10% of total external finance (equity + debt) whereas it is above 80% of debt finance, and close to 25% of total external finance (equity + debt) in the euro zone.

As longstanding institutional investors, insurers represent €17,000 billion in net investments worldwide, half of which in Europe. Insurers also play an important role with respect to the long-term financing needs of banks.

TOWARDS A MODIFICATION OF THE TRADITIONAL PORTFOLIO ALLOCATIONS OF INSURERS TO THE DETRIMENT OF INVESTMENTS IN EQUITY AND CORPORATE BONDS

For the last few years, institutional investors have reduced their investments in the equity market. Shares have fallen from a former average of 20 to 30% of insurers' balance sheets to a mere 3 to 7% today. Total divestment by European insurers over the past decade has been estimated at €400 billion. This trend has not been caused by regulatory changes only. Equity markets have undergone two acute crises over the last ten years, partly contributing to investors' disengagement.

The incentive given by Solvency II to adapt the least risky investment strategies will have negative consequences on investors' long-term and corporate financing capacities, which contribute most to economic growth. A recent study conducted by the OECD in 2011 on long-term investment shares the same concerns "*The introduction of Solvency II in the EU expected in 2013 may heighten the procyclical nature of investment strategies among these institutions [...] At the same time, Solvency II will penalise insurers for holding assets with high volatility such as equity: there is thus*



expected to be a migration away from equity to fixed income assets which will lower overall portfolio variability. While this may reduce the magnitude of pro-cyclicality effects, it also likely to lead to lower exposure to less liquid, long term assets”.

Moreover, there is no doubt that Solvency II, combined with the new accounting standards, has also caused insurers to turn away from investing in equity. Property investment by insurers will also be reduced as the equity costs for those investments will increase. The enforcement of new capital rules will only further accelerate this divestment. Certainly, mitigation measures, such as countercyclical mechanisms (dampener) were introduced in the Solvency II directive, but they will not reverse this trend. The capital requirements of Solvency II are calculated very strictly substantially overestimating risk. Requirements should therefore be re-specified and calibrated and adequate transition rules are necessary.

FOLLOWING THE FINANCIAL REPORTING STANDARDS REFORM (IFRS), THE VALUATION AT “FAIR VALUE,” OR RATHER AT CURRENT MARKET VALUE, OF INSURANCE COMPANIES’ ASSETS BECAME WIDESPREAD.

The second phase of this reform, anticipated by Solvency II, will also extend the use of market value to insurers’ liabilities. This will not encourage insurance companies to invest in equity markets. Holding stock valued at current market value increases the volatility of results, of book value and of the share price. In a situation of crisis or equity market slump, institutional investors will be less inclined to play the countercyclical role they typically played in the past, which consisted in purchasing shares whose value has gone down.

According to the specifications, proposed by the European Commission, of the fifth impact study (QIS 5), corporate bonds currently present a risk that is 70% higher than before the crisis, thereby justifying the need for additional capital of a similar percentage. This would automatically reduce insurers’ exposure to corporate bond-related risk.

A recent study by Morgan Stanley and Oliver Wyman pointed out that insurers’ investment in long-term debt will be:

- more costly than investment in short-term debt, since capital requirements covering the spread risk rise as durations increase. E.g. capital requirements for 10 years: 11.5% vs. capital requirements for 3 years: 3.5%,
- less profitable than investment in short-term debt: a 3-year debt yield is three times higher than a 10-year debt yield.

The study concludes that, from now on, insurers will invest more in bonds with a shorter duration (average of 3 years), to the detriment of long-term investments.

Solvency II therefore also incites insurers to invest less and for shorter periods of time in corporate bonds.



ACCESS TO BANK LENDING WILL BECOME MORE DIFFICULT AND COSTLIER

The new Basel III requirements will imply tighter and costlier access to bank lending and corporates will be encouraged to favour bonds issuance vs. borrowing from banks.

Moreover, due to specific hypothesis used to calculate liquidity ratios during a crisis period, some activities will be particularly impacted:

- Liquidity lines to corporates (commercial paper programmes) and to financial institutions (in particular financial subsidiaries of corporate and asset-backed commercial paper vehicles), implying that banks will severely restrict liquidity access;
- Long-term credit (due to their cumulative effect in time) - mortgage credit, export credit or project financing will also see a tightening of their finance conditions;
- Lending to more risky counterparts with very few alternatives to bank funding (SMEs, retail) likely to be the most constrained because of a more severe treatment in the liquidity ratio.

As a consequence, corporates will be more likely to turn to markets to fund themselves, thus increasing further competition on the funding market, at a time when Solvency II will penalise insurance companies for long-term investments (see above).

We also note that both Basel III and Solvency II may lead to an increased demand for long term government bonds to the detriment of corporate financing. The combination of Basel III and Solvency II will then tighten the availability of long-term finance (equity and debt) for the corporate sector.

- ***The European economy will be the most affected region (less attractive and competitive)***

The reforms will particularly affect the European banking and insurance sector and will thus have a bigger impact on the European economy.

- European banks will be more impacted by the liquidity requirement due to their higher loan-to-deposit ratios. In the US, only the “core banks” will have to comply with Basel III. They are well capitalised and less impacted by the new capital requirements but their assets amount to barely half of the total assets of the US banking sector. Indeed, the US “Shadow Banking System”, which is still very large and is poorly or not capitalized, will remain exempt from capital requirements. For comparison, the bank credit-to-GDP ratio (mid-2009) is below 50% in the US whereas it is close to 130% in the Euro zone. Moreover government sponsored enterprises such as Fannie Mae and Freddie Mac that refinance 90% of the new mortgage lending in the USA have no equivalent in Europe where banks must finance mortgage loans with their own resources.
- Reduced risk-taking decreases the profitability of the insurance industry which makes them less attractive on financial markets. Also, Solvency II is an



exclusively European standard. Only European insurers will be disadvantaged by the sector's reduced attractiveness and profitability (institutional investors, particularly pension funds and third-country sovereign funds will not be subject to the same solvency and risk management requirements as European insurers). In non-European jurisdictions, the one-side implementation of the reform will raise major level playing field issues which will have significant commercial consequences. European insurers, obliged to comply with Solvency II, will be required to hold financial resources that are much higher than domestic operators. This means that a European insurer operating in the US would have to cover the same risks with roughly four times as much capital compared to American risk-based capital (RBC) requirements.

In the end, the reduced profitability of insurers is harmful to policyholders: it impacts on margins of companies and may lead to price rises.

As indicated above, the corporate sector is highly dependent on bank lending and insurers' long term investments. Consequently, if these sources of financing would be affected, this will in turn strongly affect these companies' activities (less investments, less jobs, less competitiveness) and ultimately the European economy.

II. THE CONDITIONS FOR FAIR AND SUCCESSFUL REFORMS

2.1. Back to fundamentals

The last two years have seen a tremendous transformation of the financial system. While the financial industry has strongly improved its risk management practices, the public sector has undertaken major regulatory reform, such as capital requirements to which the industry is committed to adapt. Nevertheless, the new regulatory framework is far from being complete and still requires extensive work, on outstanding issues as well as on interpretation and/or implementation of new measures.

It's fundamental to preserve the economic model of the European insurance and banking industries within this work so that they are not discouraged from acting as long-term investors (financing companies and the 'real economy').

2.2. Key conditions

Three key-conditions appear crucial to achieve a balanced regulation while preserving the stability of the global economy without jeopardising the key economic functions of financial institutions:

- Closely monitoring of implementation and economic impacts of reforms on the real economy and being ready to act accordingly if unintentional consequences were to materialise.
- Preserving the diversity of the financial sector is vital. The financial system comprises a variety of actors with different time and investment horizons, different levels of risk appetite and different lines of business. Stability comes as



a result of this diversity. Standardising the rules for all financial players will lead to copycat behaviour that will increase pro-cyclicality and volatility and, consequently, system instability.

- Ensuring a level playing field between jurisdictions while taking into account European specificities when necessary.

Enterprises, together with the European financial industry, are committed to a continuing constructive dialogue with the public sector during the coming implementation phase to build a more stable financial system and to restore confidence, which will be essential to support future growth.

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APPENDIX – SOLVENCY II AND BASEL III

Solvency II

Implementing measures of Solvency II should comply with the underlying principles of the Directive, in particular the holistic and economic approach. It means that risks on the whole balance sheet would be covered and would be valued with a market-consistent method.

Such an approach requires that if all future risks are taken into account in the capital requirements, then all the future profits should be recognised as Tier 1 capital, as well as deferred tax assets.

An economic approach should also truly reflect the insurance business model of insurers and the business practices of an insurance company. Therefore, the implementing measures should:

- Appropriately recognise the geographical diversification in Property & Casualties and the diversification between legal entities in the group risk margin, as diversification is the fundamental principle of insurance;
- Align the Solvency II definition of boundaries of contracts on the current business practices for the sake of clarity and consistency.

Basel III

The key elements of Basle III are the following:

- to raise the quality and the level of capital base (better risk measurement requirements, raise the minimum capital requirement ratios, capital conservation buffer and a countercyclical buffer, address the risks of 'systemically important banks'),
- to enhance risk capture (a 'non risk-based' leverage ratio, capturing both on- and off-balance sheet exposures and derivatives),
- to introduce new liquidity standards for the global banking system and to contain excessive leverage (creation of: a 30-day liquidity coverage ratio (LCR), a longer term structural liquidity ratio (Net Stable Funding Ratio - NSFR)

Although, these requirements are to be phased in more gradually than initially proposed (until 2019), investors may want banks to get there quickly, and may encourage ratios to go even beyond the regulated thresholds. Moreover, these reforms potentially give rise to unintended consequences across the banking sector and the economy.