# ALLEN & OVERY

# The future of credit

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# Executive summary

We asked our market leading regulatory and finance lawyers to assess whether new regulation was having a positive, neutral or negative impact on the provision of credit.

- The deliberate and systematic tightening of regulation around the world is shrinking the size and scope of banking activity.
- Financial regulation needs to be framed in a more holistic, macro-economic context. There is merit in broadening the debate around the role of regulation and asking whether regulation should be designed in a way that actually promotes essential financial activity.
- New regulation can always have unintended consequences. But with so much new financial regulation coming at once – the so-called "Tower of Basel" – the scope for unintended consequences is staggering: Dodd-Frank in the U.S. alone is on track to run to 30,000 pages; additions to Europe's rule book could top 60,000 pages; Europe's top 350 banks will need to hire more than 70,000 new compliance specialists.
- Authorities must consider what steps they can take to free up the provision of beneficial credit – whether from traditional or alternative sources. If they fail to take a radical approach to this issue, we believe business will continue struggling to access finance, with clear consequences for broader economic growth.
- Bank balance sheets remain substantial but underutilised. The FSB's own statistics show that bank assets grew by USD26.6 trillion between 2007 and 2011, over the same period shadow banks' share of financial assets decreased from 27% to 25%. This would appear to challenge the FSB's own assertion that greater regulation of banks will create incentives for some bank-like activities to migrate to the non-bank financial space.
- The FSB's "Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities" indicates that shadow banks will, in fact, be regulated like banks – despite the benefits these alternative providers can bring to the real economy. This also ignores the fact that different participants in the financial markets pose differential degrees of systemic risk, and may not merit any intervention at all.
- We believe this is taking regulation way too far down the stability path.
- The market now faces years of regulatory wrangling before any of these proposals are implemented by national regulators, who are being given plenty of scope to interpret the policy framework in a way that best suits their market. Given that fact, we are likely to see a huge increase in uncertainty - at precisely the time when the financial markets are screaming out for greater certainty, not less.
- Banks will still be the pivotal players in structuring large, complex financial transactions, where multiple pools of capital need to be accessed. Opportunities for alternative providers will emerge but gradually.
- The volume of legislation seems disproportionately large and the scope for differential national implementation and extraterritoriality is immense. The rules are overly complex and lack the coherent design needed to facilitate an orderly flow of credit.
- Policy makers face a crucial choice here: making the financial system so safe in the name of financial stability that it is unworkable and creates paralysis, or accepting that a functioning financial system carries a degree of risk and should be promoted as such.
- Our view is that the impact of regulatory reform is disabling, rather than enabling, the flow of credit in the global financial system.

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# The need to stand back and consider the future of credit

Much has been said - and even more written - about the global regulatory response to the financial crisis. But, given the protracted global economic downturn, it is perhaps only now that it is appropriate to assess the impact of that response and its effect on the supply of credit to the wider economy.

Governments, through the G20, have tried to stamp out the risky practices perceived to have caused the crisis by instructing regulators to "strengthen financial regulation". The response has been overwhelming. It has resulted in the largest increase in financial sector regulation ever seen.

We believe now is the right time to ask some fundamental questions about the effect of this change.

What has been the cumulative impact of all this regulation? Has the pendulum swung too far already? What is the role of regulation now and in the future?

If, as appears to be the case, regulators have been mandated to be the guardians of financial stability at any cost, will there be a substantial retraction of financial activity, regardless of the adverse economic consequences that might have? Is this approach - while understandable given the huge public cost of the crisis - capable of spreading credit capacity in unpredictable directions?

And is there a better way forward?

If, as we believe, financial regulation needs to be framed in a more holistic, macro-economic context, is there merit in broadening the debate and asking whether regulation should be designed in a way that actually promotes essential financial activity, in a proactive way?

To reach an answer, we asked our market-leading regulatory and finance lawyers to assess whether the black letter law being introduced through new regulation was having a positive, neutral or negative impact on the provision of credit across 11 separate areas of finance in 13 key jurisdictions around the world.

Our research came to one overriding conclusion:
the deliberate and systematic tightening of regulation around the world is shrinking the size and scope of banking activity.

Few argue against the need for better regulation to prevent another financial crisis. But to search for answers, regulators and governments have turned – or are turning – their attention to devising new ways to regulate each of the many different, individual financial activities. The result is a welter of new rules and a tide of massive change which is likely to have much wider economic impacts.

These changes come in many guises. They include Basel III, Capital Requirements Directive IV, the Recovery and Resolution Directive, the Independent Commission on Banking (UK), the EU's Liikanen Report, Dodd-Frank, EMIR, AIFMD and the Financial Stability Board's shadow banking review.

But the effect of the most important regulatory changes focus on one main issue - the imposition of much higher (in size and quality) capital requirements for banks and investment firms, with particular emphasis on global banking institutions which are systemically-important.

Other issues compound the situation. Leverage ratios and liquidity buffers and ratios will further constrain banks' options. Securitisations, the traditional lifeline of bank funding, are also being made more difficult to create and will receive less beneficial treatment.

Furthermore, structural changes separating trading and other investment activity from traditional banking – and/or "ringfencing" bank deposits – will have a huge impact, proving costly and disruptive not just for universal banks but for all those banks inadvertently caught in the crossfire.

## The law of unintended consequences

The imposition of new regulation can always have unintended consequences. But with so much new financial regulation coming at once – the so-called "Tower of Basel" – the scope for unintended consequences here is simply staggering.

Andrew Haldane, Executive Director for Financial Stability at the Bank of England, put it into context in a recent speech in the U.S.

He predicted that the Dodd Frank Act in the United States, alone, was on track to run to 30,000 pages of new regulation. He estimated Europe's directives and regulations on capital, crisis management, deposit guarantees, short-selling, market abuse, investment funds, alternative investments, venture capital, OTC derivatives, markets in financial instruments, insurance, auditing and credit rating, could see additions to Europe's rule book top 60,000 pages.

Elsewhere it's been estimated that Europe's 350 banks, with total assets over EUR1 billion, will need to hire more than 70,000 new compliance specialists to meet the growing mountain of regulatory demands.

## The future of credit

We believe that policy makers need to take a long, hard look at the cumulative effect of this massive regulatory reform agenda.

In particular, the authorities must consider what steps they can take to free up the provision of beneficial credit – whether from traditional or alternative sources.

If they fail to take a radical approach to this issue, we believe business will continue struggling to access finance, with clear consequences for broader economic growth.

Policy makers and regulators need to ask what alternative sources of credit exist to fill the gaps left by the banks and whether alternative credit providers have the capacity to respond on the scale required – a question made all the more urgent by the current state of the global economy and the current squeeze on corporate credit.

The calculations they have to make here are far from straightforward, as a number of recent reports have highlighted.

For example, it's emerged that bank balance sheets are not shrinking as much, or as fast, as might be expected. The Financial Stability Board's own statistics show that bank assets grew by USD26.6 trillion between 2007 and 2011, compared with a USD4.6 trillion growth in the assets of shadow banks. These figures do seem to challenge the FSB's own assertion that: "looking ahead, authorities must be mindful that, by strengthening the capital and liquidity requirements applying to banks (an essential pillar of the G20's financial reform programme), the Basel III framework may increase the incentives for some bank-like activities to migrate to the non-bank financial space."

If banks' share of assets in the financial system grew from 45% to 48% between 2007 and 2011 (while the shadow banking system's share decreased from 27% to 25%) it seems unlikely that this migration will take place, especially in light of the FSB's proposals to squeeze alternative providers.

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Deloitte also recently reported, in its Bank Survey 2012, that banks expect deleveraging to be modest compared with past crises. It found that two-thirds of respondents planned to deleverage by less than 7.5% of total assets - this after an eight year period to 2008, Deloitte points out, when large Dutch banks doubled their assets and UK banks increased theirs more than five times.

Contrary to the FSB's assumptions, the survey also shows that banks expect this deleveraging to take up to five more years to complete and to be largely done through a natural run-off of assets. Depending on the maturity of the assets, this could lead to an even more protracted period of deleveraging.

The effect of this relatively slow-burn approach could be significant for the supply of alternative credit, because natural run-off means there will be relatively few large-scale asset sales of the sort that would allow new entrants to buy their way into the market to provide a new source of funding.

So credit is being squeezed from two directions – because of much higher capital and liquidity requirements and because bank balance sheets remain substantial but underutilised.

Where does that leave companies desperate to secure financing? Despite the vast changes facing the financial services industry, the questions corporates ask when looking for finance remain unchanged. Companies worry about the cost of credit, its availability, its terms and the speed of execution. But, as our research shows, the answers to these questions are changing in fundamental ways.

One thing is clear to finance directors: the basic rules of supply and demand are in the driving seat today. As the availability of credit continues to shrink, its cost is being driven up.

While terms have not changed fundamentally the squeeze on availability means companies are having to consider a wider range of financing options. This is starkly demonstrated through global high yield bond issuance reaching USD110.3bn in the third quarter of 2012, the highest quarterly level since records began in 1980, according to data from Thomson Reuters.

Other tactics being employed across the markets include "amend and extend" deals in leveraged finance, a noticeable increase in private placements in bond markets, the use of covered bond structures and export credit agency guarantees for bond issues in asset finance, as well as insurers and fund managers stepping in to fill some of the gap in real estate and infrastructure finance.

## Shadow boxing

Many people have predicted that alternative credit providers will fill gaps in the market, as banks quit areas now considered too burdensome or non-core.

But the FSB's "Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities" appears to contradict this. It indicates that shadow banks will, in fact, be regulated like banks. The focus of the framework is on credit intermediation activities by non-bank financial entities. These entities are close in nature to traditional banks in that they are either systemically linked to the traditional banking system or are affected by the same "run" risks associated with the activity of maturity transformation, which is the very essence of traditional banking.

The FSB acknowledges the benefits these activities can bring to the financial system and real economy, for example by providing alternative funding to companies and creating competition in financial markets, which may lead to innovation, efficient credit allocation and cost reduction.

But the FSB also believes non-bank credit intermediation entities may create regulatory arbitrage opportunities because they are not subject to the same prudential regulation as banks, despite potentially creating some of the same systemic risks in the financial system.

These statements appear to contradict each other and ignore the fact that different participants in the financial markets pose differential degrees of systemic risk, and that many may not merit any intervention at all.

The FSB is focusing its regulatory recommendations across five broad economic activities:

– management of client cash pools with features that make them susceptible to runs

– loan provision that is dependent on short-term funding

– intermediation of market activities that is dependent on short-term funding or on secured funding of assets

– facilitation of credit creation

– securitisation and funding of financial entities

The FSB has come up with "Policy toolkits" to help regulators deal with the risks they perceive shadow banks present to the financial system.

The toolkits broadly prescribe full-on regulatory supervision. They call for the expansion of the regulatory perimeter to include non-regulated entities, capital requirements, limits on leverage, liquidity buffers and a range of restrictions on the types of activities entities can engage in, limits on asset concentrations, and restrictions on the scale and scope of business.

All this makes it difficult to see how non-bank providers of credit will be able to escape bank-like regulation as it provides ample scope for those regulators who are keen to act against a broad range of suspected malice in the financial system.

We believe this is taking regulation way too far down the stability path.

The market now faces years of regulatory wrangling before any of these proposals are implemented by national regulators, who are being given plenty of scope to interpret the policy framework in a way that best suits their market. Given that fact, we are likely to see a huge increase in uncertainty - at precisely the time when the financial markets are screaming out for greater certainty, not less.

The proposals suggest we're unlikely to see any proactive and controlled measures to liberalise corporate lending markets. In Europe, for example, tackling the many different licensing rules in rival jurisdictions could make it much easier for non bank institutions to extend credit; and removing the restrictions on UCITS from buying interests in loans could also help to facilitate alternative credit capacity.

But both the FSB in its report on shadow banking and Dodd-Frank point to a different approach: where entities used to be regulated, now it is going to be regulation by activity and risk.

This means that only those institutions with the necessary resources to structure themselves in a way that enables them to comply with the regulations will be able to compete.

## Banks provide the bedrock – but do governments want to facilitate credit flows?

Despite the volume of change in prospect, one thing remains constant: banks will still be the pivotal players in structuring large, complex financial transactions, where multiple pools of capital need to be accessed. As shown above, their balance sheets are being restructured but remain very substantial, with assets growing by 25% in the past five years.

However you look at the reforms being proposed, the volume of legislation seems disproportionately large and the scope for differential national implementation and

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extraterritoriality is immense. The rules are overly complex and lack the coherent design needed to facilitate an orderly flow of credit.

They ignore the fact that the financial crisis was actually sparked by institutions failing to observe very simple rules of prudence and risk management, and by central banks increasing the supply of cheap money. Both led to a mispricing of risk more generally.

There is now an inherent contradiction between many governments' desire to remove risk from the system and their insistence that banks should lend more. In any downturn there are fewer creditworthy borrowers and an insistence that banks lend to struggling businesses may increase risk in the system.

Policy makers face a crucial choice here: making the financial system so safe in the name of financial stability that it is unworkable and creates paralysis, or accepting that a functioning financial system carries a degree of risk and should be promoted as such.

While paralysis in the system may eventually create opportunities for some new players to emerge, it will be a slow process rather than a sudden switch. Meanwhile, the financial system is left dazed and confused. Very few people understand what the swathes of new regulation mean, and even fewer understand how it all fits together, especially when regulators around the world are approaching the issue in fundamentally different ways.

Our view is that the impact of regulatory reform is disabling, rather than enabling, the flow of credit in the global financial system. In the longer term it could substantially damage areas of financial activity that are understood and manageable, giving rise to a new breed of finance that is altogether less controllable and more unpredictable.





# Regulatory impact analysis

## METHODOLOGY:

1. We have undertaken legal research into two distinct areas: i) the current capacity of a number of key participants in the financial markets to engage in various financial activities on a primary or secondary basis; and ii) the impact that current crystallised regulatory reform measures will have on both the capacity and the regulatory burden for such participants engaging or continuing to engage in the relevant designated financial activities.

2. The analysis has been conducted in relation to business falling within the geographical scope of applicable regulatory regimes irrespective of whether it is conducted from within the jurisdiction or into the jurisdiction.

3. In relation to covered bonds, we have indicated the position from the perspective of banks acting as issuers. For all other designated entities, in relation to covered bonds, we have indicated the position from the perspective of them acting as investors.

4. As regards securitisation, the position is described from the perspective of the banks originating or sponsoring securitisation transactions. For all other designated entities, in relation to securitisation, we have indicated the position from the perspective of them acting as investors.

5. In relation to unregulated or lightly regulated investment funds, where the package of regulatory reform measures suggests no change in the regulatory burden or capacity of a designated entity to engage in a particular designated financial activity BUT the broader regulatory environment as it impacts other potential participants suggests that this is an advantageous position, we have indicated a positive outlook.

6. For derivatives and repo transactions, the position is described from the perspective of the banks acting as dealers while for all other designated entities we have indicated the position from the perspective of them acting as counterparties.

7. The analysis in relation to insurance companies in Europe does not take account of Solvency II given ongoing political discussions and uncertainty regarding its final form.

8. The table is necessarily a distillation of a substantial amount of raw legal data collated from a large number of jurisdictions and as such, it does not attempt to deal with all permutations presented by the various designated entities.

# The impact of regulation on the provision of credit

The chart below is Allen & Overy's analysis of whether current crystallised regulatory changes will be positive, neutral or negative for the various entities (outlined in the key) engaging in the financial activities listed down the left hand side of the chart in each of the countries shown, from both a capacity perspective and the regulatory burden of doing business.

**Colour key**

- Positive
- Neutral
- Negative/Unable
- N/A

**Entity key**

| Key | Entity |
|---|---|
| B | Bank (deposit taker) and investment bank |
| I | Insurance and reinsurance |
| F | Investment funds (other than UCITs) |
| U | UCITS funds including UCITS money market funds |
| NU | German non-UCITS (special) funds for institutional investors |
| RF | Luxembourg regulated investment funds (other than UCITS) |
| BHC | Bank Holding Company Non-Bank Subsidiary (e.g., BD, IA, funds) |
| NBHC | Non-Bank Holding Company, Investment Bank/Broker-Dealers |
| AMP | Asset Managers – Private Funds |
| AMRF | Asset Managers – Investment Companies/Registered Funds |
| T | Trust companies which are also regulated by the banking regulator in China |

**United Kingdom**

| Activity | B | I | F | U |
|---|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | Positive | Negative/Unable |
| Asset finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Leveraged finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Real estate finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Trade & commodity finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Project finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Covered bond | Neutral | Neutral | Neutral | Positive |
| Bond | Negative/Unable | Neutral | Neutral | Positive |
| Derivatives | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Securitisation | Negative/Unable | Neutral | Neutral | Neutral |
| Repo | Negative/Unable | Neutral | Neutral | Negative/Unable |

**France**

| Activity | B | I | F | U |
|---|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | Positive | Negative/Unable |
| Asset finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Leveraged finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Real estate finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Trade & commodity finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Project finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Covered bond | Neutral | Neutral | Neutral | Positive |
| Bond | Negative/Unable | Neutral | Neutral | Positive |
| Derivatives | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Securitisation | Negative/Unable | Neutral | Neutral | Neutral |
| Repo | Negative/Unable | Neutral | Neutral | Negative/Unable |

**Germany**

| Activity | B | I | F | NU |
|---|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | Positive | Neutral |
| Asset finance | Negative/Unable | Neutral | Positive | Neutral |
| Leveraged finance | Negative/Unable | Neutral | Positive | Neutral |
| Real estate finance | Negative/Unable | Positive | Positive | Neutral |
| Trade & commodity finance | Negative/Unable | Neutral | Positive | Neutral |
| Project finance | Negative/Unable | Neutral | Positive | Neutral |
| Covered bond | Neutral | Neutral | Neutral | Neutral |
| Bond | Negative/Unable | Neutral | Neutral | Neutral |
| Derivatives | Negative/Unable | Neutral | Neutral | Neutral |
| Securitisation | Negative/Unable | Neutral | Neutral | Neutral |
| Repo | Negative/Unable | Neutral | Neutral | Neutral |

**Spain**

| Activity | B | I | F | U |
|---|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | Positive | Negative/Unable |
| Asset finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Leveraged finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Real estate finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Trade & commodity finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Project finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Covered bond | Neutral | Neutral | Neutral | Positive |
| Bond | Negative/Unable | Neutral | Neutral | Positive |
| Derivatives | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Securitisation | Negative/Unable | Neutral | Neutral | Neutral |
| Repo | Negative/Unable | Neutral | Neutral | Negative/Unable |

**United States**

| Activity | B | BHC | NBHC | I | AMP | AMRF |
|---|---|---|---|---|---|---|
| Corporate lending | Negative/Unable | Negative/Unable | Negative/Unable | Neutral | Neutral | Neutral |
| Asset finance | Negative/Unable | Negative/Unable | Negative/Unable | Neutral | Neutral | Neutral |
| Leveraged finance | Negative/Unable | Negative/Unable | Negative/Unable | Neutral | Neutral | Neutral |
| Real estate finance | Negative/Unable | Negative/Unable | Negative/Unable | Neutral | Neutral | Neutral |
| Trade & commodity finance | Negative/Unable | Negative/Unable | Negative/Unable | Neutral | Neutral | Neutral |
| Project finance | Negative/Unable | Negative/Unable | Negative/Unable | Neutral | Neutral | Neutral |
| Covered bond | Neutral | Neutral | Neutral | Neutral | Neutral | Neutral |
| Bond | Negative/Unable | Negative/Unable | Negative/Unable | Neutral | Neutral | Neutral |
| Derivatives | Negative/Unable | Negative/Unable | Negative/Unable | Negative/Unable | Negative/Unable | Negative/Unable |
| Securitisation | Negative/Unable | Negative/Unable | Negative/Unable | Neutral | Negative/Unable | Negative/Unable |
| Repo | Negative/Unable | Neutral | Neutral | Neutral | Neutral | Neutral |

**Italy**

| Activity | B | I | F | U |
|---|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Asset finance | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Leveraged finance | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Real estate finance | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Trade & commodity finance | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Project finance | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Covered bond | Neutral | Neutral | Neutral | Positive |
| Bond | Negative/Unable | Neutral | Neutral | Positive |
| Derivatives | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Securitisation | Negative/Unable | Neutral | Neutral | Neutral |
| Repo | Negative/Unable | Neutral | Neutral | Negative/Unable |

**Belgium**

| Activity | B | I | F | U |
|---|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | Positive | Negative/Unable |
| Asset finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Leveraged finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Real estate finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Trade & commodity finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Project finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Covered bond | Positive | Neutral | Neutral | Positive |
| Bond | Negative/Unable | Neutral | Neutral | Positive |
| Derivatives | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Securitisation | Negative/Unable | Neutral | Neutral | Neutral |
| Repo | Negative/Unable | Neutral | Neutral | Negative/Unable |

**Netherlands**

| Activity | B | I | F | U |
|---|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | Positive | Negative/Unable |
| Asset finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Leveraged finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Real estate finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Trade & commodity finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Project finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Covered bond | Neutral | Neutral | Neutral | Positive |
| Bond | Negative/Unable | Neutral | Neutral | Positive |
| Derivatives | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Securitisation | Negative/Unable | Neutral | Neutral | Neutral |
| Repo | Negative/Unable | Neutral | Neutral | Negative/Unable |

**Luxembourg**

| Activity | B | I | RF | U |
|---|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | Positive | Negative/Unable |
| Asset finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Leveraged finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Real estate finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Trade & commodity finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Project finance | Negative/Unable | Neutral | Positive | Negative/Unable |
| Covered bond | Neutral | Neutral | Neutral | Positive |
| Bond | Negative/Unable | Neutral | Neutral | Positive |
| Derivatives | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Securitisation | Negative/Unable | Neutral | Neutral | Neutral |
| Repo | Negative/Unable | Neutral | Neutral | Negative/Unable |

**China**

| Activity | B | I | F | T |
|---|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | N/A | Negative/Unable |
| Asset finance | Negative/Unable | Neutral | N/A | Negative/Unable |
| Leveraged finance | Negative/Unable | Neutral | N/A | Negative/Unable |
| Real estate finance | Negative/Unable | Neutral | N/A | Negative/Unable |
| Trade & commodity finance | Negative/Unable | Neutral | N/A | Negative/Unable |
| Project finance | Negative/Unable | Neutral | N/A | Negative/Unable |
| Covered bond | N/A | N/A | N/A | N/A |
| Bond | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Derivatives | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Securitisation | Negative/Unable | Neutral | Neutral | Negative/Unable |
| Repo | Negative/Unable | Neutral | Neutral | Negative/Unable |

**Hong Kong**

| Activity | B | I | F |
|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | Neutral |
| Asset finance | Negative/Unable | Neutral | Neutral |
| Leveraged finance | Negative/Unable | Neutral | Neutral |
| Real estate finance | Negative/Unable | Neutral | Neutral |
| Trade & commodity finance | Negative/Unable | Neutral | Neutral |
| Project finance | Negative/Unable | Neutral | Neutral |
| Covered bond | Neutral | Neutral | Neutral |
| Bond | Negative/Unable | Neutral | Neutral |
| Derivatives | Negative/Unable | Neutral | Neutral |
| Securitisation | Negative/Unable | Neutral | Neutral |
| Repo | Negative/Unable | Neutral | Neutral |

**Singapore**

| Activity | B | I | F |
|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | Positive |
| Asset finance | Negative/Unable | Neutral | Positive |
| Leveraged finance | Negative/Unable | Neutral | Positive |
| Real estate finance | Negative/Unable | Neutral | Positive |
| Trade & commodity finance | Negative/Unable | Neutral | Positive |
| Project finance | Negative/Unable | Neutral | Positive |
| Covered bond | Neutral | Neutral | Neutral |
| Bond | Negative/Unable | Neutral | Neutral |
| Derivatives | Neutral | Neutral | Neutral |
| Securitisation | Neutral | Neutral | Neutral |
| Repo | Neutral | Neutral | Neutral |

**Australia**

| Activity | B | I | F |
|---|---|---|---|
| Corporate lending | Negative/Unable | Neutral | Positive |
| Asset finance | Negative/Unable | Neutral | Positive |
| Leveraged finance | Negative/Unable | Neutral | Positive |
| Real estate finance | Negative/Unable | Neutral | Positive |
| Trade & commodity finance | Negative/Unable | Neutral | Positive |
| Project finance | Negative/Unable | Neutral | Positive |
| Covered bond | Positive | Neutral | Neutral |
| Bond | Negative/Unable | Neutral | Neutral |
| Derivatives | Negative/Unable | Neutral | Neutral |
| Securitisation | Negative/Unable | Neutral | Neutral |
| Repo | Negative/Unable | Neutral | Neutral |

**Russia**

| Activity | B | I | F |
|---|---|---|---|
| Corporate lending | Neutral | Neutral | Neutral |
| Asset finance | Neutral | Neutral | Neutral |
| Leveraged finance | Neutral | Neutral | Neutral |
| Real estate finance | Neutral | Neutral | Neutral |
| Trade & commodity finance | Neutral | Neutral | Neutral |
| Project finance | Neutral | Neutral | Neutral |
| Covered bond | Neutral | Neutral | Neutral |
| Bond | Neutral | Neutral | Neutral |
| Derivatives | Neutral | Neutral | Neutral |
| Securitisation | Neutral | Neutral | Neutral |
| Repo | Neutral | Neutral | Neutral |

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# Corporate lending

Corporate lending has long been the preserve of banks. Traditionally they were the only entities that had the internal expertise and risk management systems necessary to originate, and the balance sheet size to fund corporate lending.

In many countries corporate lending is largely controlled by local regulations which dictate who can lend and predominantly that means licensed local banks.

Governments around the world have stated a desire for an increase in corporate lending to help fuel a recovery in global markets. Some have even offered to slow the regulatory implementation timetable to help this. But the structural changes to the operations of banks being sought are so fundamental and will take so many years to implement that moving a deadline does not change the need for banks to start tackling these challenges now.

The pressure on banks is already leading to a number of new players exploring the possibility of entering the market. So far this has largely been in the form of buying discrete portfolios of loans or other exposures.

While banks are deleveraging to an extent, most loan portfolio sales have come from banks having to dispose of books under state aid requirements following forced acquisitions at the height of the banking crisis. Others are putting portfolios into run-off.

Our analysis indicates an increasing scope for some investment funds and, in some market, insurance companies to compete in this area. For insurers there is some capacity to compete, as has already been seen in the form of "liquidity swaps" and other transactions, whereby insurers "lend" their excess liquidity to the banking sector. But insurers are constrained by their cost of capital and lack of infrastructure. The impact of regulatory trends is also contradictory and evolving, especially in relation to Solvency II.

For some investment funds, there are opportunities but there is a need to consider carefully relevant laws and regulations. Such funds are, however, also hampered by some of the regulatory changes. For instance, CLOs have for many years been a key source of financing for the leveraged loan market (and, to a lesser extent, corporate loan market). However, rules in Europe (and in the future also in the U.S.) requiring securitisers to hold "skin-in-the-game" have decreased the CLO market's ability to act as an effective distributor of credit in these markets, resulting in a shut-down in the CLO market in Europe.

Deleveraging is not all one-way traffic, however. Corporates too are deleveraging by using cash reserves to pay down debt. There is evidence of refinancings being done for lower amounts than the original loan as a result.

Banks' lending horizons are also shrinking, with signs that banks are shortening tenors due to the prohibitive cost of their capital for longer-term deals.

A significant aspect of corporate lending has always been in the ancillary products that banks can sell to large corporations. Alternative lenders, however, may have less interest in ancillary products and a greater focus on return from lending. This may lead to changing pricing dynamics in the corporate lending market.

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# Asset finance

The financial and eurozone crisis and subsequent market downturn have seen a significant reduction in new money lending from the major players using traditional sources of finance. Some sectors of the market have been hit harder than others, with shipping in the container and bulker markets particularly feeling the pain while offshore shipping and LNG remain buoyant. This has resulted in some of the traditional banks severely cutting back their exposure to these markets or exiting altogether. Trying to find willing buyers for their portfolios has not been an easy task as there has been a mismatch between sellers' and buyers' expectations on portfolio prices. This is now slowly changing as sellers are more prepared to sell at less than par, which is creating a market for new entrants to acquire sizeable portfolios and gain entry to these markets.

While disposals have taken place there are also a large number of banks who have put their portfolios into run-off so as to avoid crystallising losses. This has created an element of paralysis in the market as banks are unwilling to lend on the scale they used to, but are unable to completely pull out of the market. But this is now starting to be worked through.

A number of Japanese banks, however, do not seem to have the same constraints (or lack of funds) as many of the European banks. As a result we are seeing new entrants emerge and some Japanese banks significantly increasing their market share. This was highlighted in 2012 when Sumitomo Mitsui Banking Corporation (SMBC) purchased a large aviation portfolio from RBS Aviation Capital for USD7.3bn, making it one of the largest leasing companies in the world.

While the export credit agencies (ECAs) have played, and will continue to play, a key role in supporting the export of new aircraft and ships, in turn helping manufacturers maintain healthy order books, the impact of Basel III will mean that banks across Europe will have to adjust their balance sheets and capital structures in order to meet the new requirements. This will lead to an inevitable increase in pricing and reduction in the size of their balance sheets. Added to this, the new aircraft sector understanding that will come into force at the beginning of 2013 will see a significant rise in the premiums that are paid by borrowers to access ECA finance, which will have a direct impact on the attractiveness of the support provided by these agencies.

Asset finance is turning its attention to capital markets techniques that enable banks to use their portfolios as a revolving pool of collateral for a bond or note issue. This helps banks unlock the liquidity that is tied up in a loan portfolio that would otherwise be sitting in run-off.

Another trend we are seeing is that of ECAs offering guarantees on bond issues. In a market where traditional bank finance is in short supply, the ability to tap the capital markets will offer a much needed new source of finance and when applied to existing deals, will enable banks to recycle the debt for new deals.

Looking further afield, insurance companies and pension funds have sizeable quantities of cash from policyholders and do not face the same funding issues currently affecting many of the banks. This potential new group of lenders, who have assets tied up in very low yielding sovereign debt and bonds, are looking for alternative homes for their liquid cash. Aircraft loans and some shipping loans may well fit into the search for new investments as there is a simple underlying asset with a market track record and a long-term tenor for regular returns.

# Leveraged finance

Activity levels in the European leveraged finance market are currently substantially down on 2011 (which itself was flat on 2010 levels), mainly due to the lack of supply of M&A. At the same time, IPOs are not currently seen as an attractive exit option. The combination of these two factors has left some private equity investors with assets on their books they are unable to sell, but with the financing taken out to fund the acquisition of those assets nearing maturity – the so-called "maturity wall".

Currently, the lack of financing for new deals has seen existing lending syndicates frequently being prepared to take part in "amend and extend" agreements, essentially extending the maturity of the existing facilities by a couple of years in return for a combination of consent and participation fees, partial prepayments (sometimes financed from the proceeds of bonds issued by the borrowers in the currently resurgent high yield market) and upwards repricing of the debt. From the banks' point of view, this avoids a default by companies that are unlikely to be unable to refinance all of their debt in a radically different market. However, with the CLOs and CDOs which made up a large part of pre-crunch lending syndicates now themselves often nearing the end of their reinvestment periods, this will not necessarily be a solution for those borrowers which have not already gone down this route. A recent research paper by Moody's said that the refinancing burden for European LBOs "remains challenging" and predicted significant default rates for those companies which have not already taken steps to deal with maturity issues in respect of their debt. This in turn may lead to an increase in M&A activity as existing owners are forced to put their investments on the market, or existing lenders take enforcement proceedings and we see disposals by insolvency officials appointed by them.

The lack of bank and (in the absence of CLOs) other loan finance has also been one of the factors leading to the current boom in high yield issuance, as is demonstrated by global issuance of high yield bonds reaching USD110.3bn in the third quarter of 2012, the highest quarterly figure since records began in 1980, according to data from Thomson Reuters.

Mezzanine finance remains an option for European companies, particularly in the mid-market for companies requiring less debt than that necessary to create the liquidity to make a high yield bond issue viable, or where the amount of debt required makes the substantial issue costs associated with a high yield issue unattractive.

In the debt markets, as in much else, nature abhors a vacuum and we are consequently seeing a number of senior debt funds being created to fill the void left by reduced lending by banks to the leveraged finance market and the maturity of the CLOs and CDOs which were so important in driving the growth of that market in 2005-7.

*In the debt markets, as in much else, nature abhors a vacuum and we are consequently seeing a number of senior debt funds being created to fill the void*





# Real estate finance

In Europe, real estate finance is one of the markets where we are seeing tangible signs of non-bank credit becoming available, largely from insurance companies and fund managers.

While this is still an emerging trend with a small number of insurers up and running in this space there is increasing discussion in the market about other insurers being in set-up mode. Funds have also been active in buying portfolios and are now actively setting up platforms to lend.

This trend is largely driven by a wholesale deleveraging by banks with exposure to the commercial real estate market. Morgan Stanley's latest Blue Paper estimates banks with exposure to the EUR2.4 trillion of lending in the commercial real estate sector have deleveraged their exposure to the tune of EUR140bn, out of the EUR600bn they estimate banks will deleverage over the next four to five years.

It is also being driven by regulators rejecting banks' ability to use an internal model approach under Basel III. This approach allowed banks to use their own internal models to evaluate risk, which then determined how much capital must be held against that exposure. The enforcement of a standardised approach to risk is driving up the amount of capital that banks must hold against real estate assets.

This is creating something of an arbitrage opportunity for insurers as the capital treatment they receive for real estate assets under Solvency II, the new insurance regulations, is less onerous than for banks.

This, combined with the losses that banks have already realised from the financial crisis, or large portfolios being put into run-off in order to avoid realising losses, means there are fewer banks actively lending in this part of the market compared to pre-crisis.

Morgan Stanley estimates that up to EUR200bn could come from alternative sources, leaving a sizeable shortfall in the EUR400bn to EUR700bn expected from bank deleveraging. Although DTZ put the funding gap more in the region of EUR150bn.

Alternative providers' interest in the market is largely driven by the desire to chase yield in a low interest rate environment. Margins on real estate finance have increased from around 80-100 basis points (bp) above LIBOR for some deals in the UK, to between 250bp and 350bp. This may be an attractive proposition for those able to help plug the gap but has serious implications for those in need of finance.

All these forces are combining to create a potential shift in the make up of credit providers within the real estate market.

However, there remain a number of banks who hold a strong position in the market and are unlikely to want to give that up. It is likely that there will be a greater variety of players offering credit in the real estate finance market and this migration appears to be well under way.

# Trade, commodity and export finance

Trade, commodity and export finance (TCF) is another area coming under increasing pressure. Macro economic indicators point to an increased demand for commodities in the medium and long term and an increased financing need.

Due to the increasing need for finance from trading companies and other players in the commodities supply chains, rising commodities prices, the lack of liquidity in the market and the risks associated with financing this sector, the market is changing from traditional bilateral loans done in-house to club and syndicated loans and secured, multi-jurisdictional borrowing base facilities. Commodities traders are also increasingly turning to the capital markets (debt and equity) for financing.

TCF transactions are also becoming increasingly complex (e.g. structured borrowing base facilities, commodities hedging structures, commodities repo structures, commodities securitisations).

Capital adequacy regulations make certain TCF transactions (e.g. uncommitted credit facilities) more attractive for financial institutions.

There are a large number of government initiatives under way across Europe to kick start export financing. This is helping banks act as an intermediary to the non-bank market. The new reality of the capital treatment of long tenor debt is proving a challenge for banks to be able to provide it themselves and most government initiatives are geared towards providing a solution for the banks' liquidity squeeze.

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# Project finance

The overlapping and interdependent worlds of projects, energy and infrastructure have seen a number of trends emerging as a result of the financial crisis. As long term lending has become more expensive for banks and so borrowers, with opportunities for limited recourse financing of energy and infrastructure expanding, the public and private sectors have both responded in positive ways.

The public sector response to the need for capital projects in the developing world is driven as much by self interest as altruism. Population growth in the developing world and the promise of new markets create demand for exports, the need for natural resources and opportunities for Western economic growth. Export credit agencies, funded by governments, have been given additional resources and multilateral agencies, such as EIB and World Bank, have rightly made it their business to pick up some of the shortfall in commercial bank funding of projects.

The private sector has witnessed banks reducing balance sheet exposure to projects by selling debt portfolios that involve project assets matched by a renewed desire to involve the capital markets in projects at the development stage (rather than through refinancing or funding existing operating infrastructure and energy businesses that may have started as bank funded projects). In addition to the international project bond market, which has worked well in a number of markets, we are seeing an expansion. A number of products are in development, including various solutions that will result in a greater use of project bonds (including products that use the new EIB supported project bond and various alternatives such as the ING developed PEBBLE product and the Hadrian's Wall solution).

We are also beginning to see infrastructure debt funds as a source of capital for funding infrastructure projects/assets and also expect shortly to see Government guarantees (for example in the UK) being used in support of senior debt.

What is beyond doubt is that over the next few years, as well as traditionally funded bank projects (usually locally funded with strong sponsors), we will see a growing array of new capital sources participating in projects, energy and infrastructure transactions that help deliver new assets in new ways.

One traditional place to look for examples of government supported project finance is in the ECA world. The participation of an ECA can act as a catalyst in mobilising both loan financing and equity investment in the project finance market. Their participation can increase liquidity either through the provision of cover for commercial banks – enabling banks to provide long-term debt – or through the provision of direct loans to the project company. In an economic environment with liquidity constraints and low appetite for risk, funding for many projects simply would not be available in the commercial bank market, at least not on economically viable terms, without ECA funding and support. This is especially true for projects in emerging markets and "mega" projects.

ECA cover has also, historically, proven to be beneficial, in many cases, from a capital adequacy and bank regulatory standpoint: where an ECA provides comprehensive cover, banks can book the loans so covered as credit risk on the government of the relevant country of the ECA and not a credit risk on the actual borrower or its country.

*Project and asset finance, once the domain of banks, has moved into the capital markets to seek funding.*

The advent of Basel III is, however, likely to create challenges for project lenders which will have the potential significantly to reduce if not remove these benefits. While much depends on how Basel III is ultimately implemented, at least two features of the new rules are likely to have an impact on ECA-covered long-term lending to projects: the net stable funding ratio and the leverage ratio.

The net stable funding ratio (NSFR), in simple terms, requires banks to have funding in place with a maturity of at least one year to cover their assets with a maturity of one year or more. While it is not the case that banks will have to match assets on a loan-to-loan, year-to-year basis, it is likely that this new ratio will make long-term projects lending a less attractive and more expensive endeavour, and the existence of ECA cover for a given long-term loan is unlikely to make a difference.

This ratio, then, is potentially a problem not just for ECAs but for the project finance industry as a whole. While Basel III will not be fully implemented for some years, ECAs have already begun discussing and exploring ways in which they might update their array of products to help fill a gap in medium- and long-term lending created by the NSFR. Thoughts to date have included a ramp-up in direct lending by ECAs; a willingness to work with and retooling of ECA products to suit non-bank financial institutions not subject to Basel III who enter the projects market; and also securitisation programmes.

The leverage ratio simply takes away one of the advantages of ECA backing. The leverage ratio, which simply measures exposure against capital, is intended to be "simple" and "transparent" as well as non-risk based. It is this last aspect of the leverage ratio which renders ECA cover less useful than it otherwise would be. For the purposes of calculating the leverage ratio, because the calculation is not risk-based, ECA-covered assets will be treated no differently from other assets due to risk-weighting, which has traditionally been one incentive for lenders to work with ECAs.

Project and asset finance, once the sole domain of banks and monoline wrapped bonds, has started to look to the capital markets to seek funding. This started in the form of banks financing their project and asset finance inventory through securitising or repackaging their project and asset finance assets, but has now extended to borrowers seeking direct financing/refinancing from the capital markets – so-called "project bonds".

Ironically, this is likely to require increased levels of state support for the underlying projects either through direct financial support or more accommodating underlying contractual and regulatory regimes.

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# Covered bonds

Covered bonds are corporate bonds with one important enhancement: recourse to a pool of "cover assets" that secures or "covers" the bond if the credit institution issuer becomes insolvent. Typically (but not always) the covered bond regime in a relevant jurisdiction is governed by a legislative framework, which ensures that investors in covered bonds and certain related creditors have a priority claim on the assets in the cover pool. This enhancement typically, although not always, results in the bonds being assigned 'AAA' credit ratings. Covered bonds are viewed by investors as "ultra safe". As one of the more secure types of credit, covered bonds have come out of the financial crisis comparably well in terms of regulation. For instance, in Europe, UCITS eligible covered bonds (which are covered bonds issued by an EU credit institution, where a special law exists to protect the interests of covered bondholders), have preferential treatment under the ECB lending operations. Covered bonds also have favourable treatment for liquidity calculation purposes under Basel III, and the current drafts of the Solvency II regulations will also encourage insurance company investors to favour covered bonds over, for instance, unsecured debt.

Since 2008, the favourable regulatory treatment and comparably good performance of the covered bond market have resulted in an explosion of covered bond programmes or regimes being established outside of the traditional home base of the product in Europe (especially France and Germany). For instance, covered bond programmes have been established in Canada, the U.S., Australia, Belgium, Greece, New Zealand, Turkey, Cyprus and Korea. Credit institutions in Asian regions are now looking more closely at the product – most notably in Singapore.

However, it is important to note that covered bonds cannot be the new saviour for credit institutions seeking funding. Encumbrancy limits (official or unofficial) will limit the amount of assets that can be isolated for the benefit of covered bondholders. Moreover, the cost of maintaining a covered bond programme can be high. This is because the required level of "over-collateralisation" in the cover pool, to cover the claims of covered bondholders and related creditors, is set conservatively by the rating agencies for those issuers seeking an 'AAA' or equivalent rating. Ultimately, the product can be just one of the tools in the funding tool box.

*Covered bonds are viewed by investors as "ultra safe". As one of the more secure types of credit, covered bonds have come out of the financial crisis comparably well in terms of regulation.*





# Bonds

A world where bank credit is less readily available should logically lead to a thriving bond market. And, overall, the bond markets have seen something of a return to form in 2012 with global bond issuance up 6.1% to USD2.74 trillion in the first nine months. Euro-denominated corporate issuance was also up by over 65% in the first nine months, largely on the back of efforts to move the immovable object that is Europe's sovereign debt crisis.

Across Europe there appears to be a credit migration taking place. As banks' ability to lend continues to be constrained, corporates are turning to the bond markets in order to fund themselves. Low interest rates means the benchmarks used to price bond debt make this an attractive and relatively cheap source of funding for corporates. However, this source of funding remains open only to larger corporate borrowers.

This migration is being mirrored by fund managers, with the UK's Pensions Regulator recently reporting that pension funds now hold 43.2% in gilts and fixed interest compared to 38.5% in equities – the highest allocation of gilts and fixed interest since it started compiling data in 2006 and the first time that bonds have overtaken equities.

But even this ray of hope faces a potential regulatory curtain. Both the UK, through its Vickers Report, and the EU through the Liikanen, have proposed ring-fencing banks. If bank trading sits outside the ring-fence it would likely limit the liquidity available in corporate bond trading. A less liquid market would make this source of finance more expensive, although at present the increase in demand for bonds is keeping prices low.

While the general corporate bond market will see increased demand (this is an activity which does not require any licence), bank bond issuance will remain a fraught topic given the impact of evolving bank resolution frameworks and, in particular, bail-in and depositor preference on bank capital structures.

This is making bank issued bonds less attractive and, therefore, potentially reducing the bond markets as a source of credit for banks.

Another trend that is emerging in Europe is that of corporates seeking to raise money through private placements. This has included UK and European entities looking to take advantage of deeper pools of capital in the U.S. Data from Barclays shows the U.S. private placement market surpassed USD50bn for the first time in the first 10 months of 2012, compared with USD45.1bn in the whole of 2011. While U.S. companies were the largest recipients at 40% of the total, the rest were cross-border, with about 20% from the UK, 8% from the Netherlands and 6% from France.

Private placements are, as the name suggests, offered to a smaller number of (usually) larger institutional investors. In most cases these are insurers and pension funds. As well as tapping the U.S. markets, issuers are finding there are an increasing number of investors in Europe who are keen to buy privately placed bonds. This is largely due to low returns on government bonds driving investors in search of better yields. It also provides insurers and pension funds with the longer-term investments they need from a liability perspective.

One interesting development in the UK has been the Order book for Retail Bonds (ORB), launched by the London Stock Exchange in February 2010. Developed in response to strong demand from retail investors for access to an on-screen secondary market in fixed income securities, the market has raised GBP2.2bn since inception and GBP1.2bn to the end of October this year. Issue sizes on the ORB have ranged from GBP20m to GBP260m, offering another avenue to issuers who don't want to or are unable to issue in the wholesale bond market, where the benchmark issue size tends to be closer to GBP500m. While still a comparatively small market, it is another example of both issuers and investors looking for new sources of credit.

Similar techniques, particularly distribution of bonds through a stock exchange, were also used in Italy's recent EUR18bn four-year inflation linked bond, the largest amount ever sold in a single debt offering in Europe, according to Thomson Reuters. Analysts had expected the issue to raise EUR7bn but the impressive demand from retail investors pushed the issue higher. The structure was originally only available for governments but is now available for the distribution of bonds by any entity.

# Derivatives

OTC derivatives are not routinely used as a mean of providing credit, but, used in conjunction with the extension of credit through any of the means discussed in this paper, whether as price discovery or risk management tools, their role in ensuring the availability of credit is key. Viewed from this perspective, the impact of the proposed regulation on derivatives trading will be negative.

EMIR (mandating central clearing of standardised derivative contracts and mandatory collateralisation of non-standardised contracts) and Volcker (mandating the 'push out' of swaps from the range of businesses a bank holding unsecured deposits can engage in) will have a negative impact on almost all derivative transactions for banks and other financial counterparties/high-volume dealers.

Basel III/CRD IV will have a cumulative negative impact on centrally cleared (Over The Counter (OTC) and exchange-traded) derivatives through enhanced counterparty risk requirements, including to clearing houses themselves. Additionally, these measures will also carry negative impact on market and trading book risk and commensurate capital requirements.

Given the focus on encouraging greater use of central-cleared derivatives, it is also likely that OTC derivatives will carry a comparatively higher capital charge than those that are centrally cleared.

The operational consequences of the move to central clearing of some OTC derivatives will result in enhanced collateralisation and risk management obligations, which is widely expected to constrain the OTC market. Given the state of regulation of this segment, there are unlikely to be any opportunities for significant scale arbitrage for dealing in derivatives absent a marked geographical approach (i.e. Asia Pacific countries choosing not to adopt equivalent standards, but note extra territorial application of both European and, in particular, U.S. requirements designed to tackle this potential development).

The proposal to set mandatory margin requirements for non-cleared derivatives could be seen as another measure to encourage derivatives trading into central clearing by creating a less efficient trading environment for OTC derivatives. While it is helpful that the Basel Committee is seeking to tackle this issue globally, the costs of its proposals seem extraordinarily high. The combined effect of the regulatory capital requirements applicable to non-cleared derivatives and the proposed requirement would, if not properly implemented, be likely to make trading in non cleared derivatives prohibitively expensive for some institutions. The liquidity implications of segregated margin requirements may carry unintended consequences.

Coming on top of changes to liquidity requirements for banks and increased collateral demands by central counterparties on cleared OTC derivatives, the ever-increasing requirement for liquid assets to support or collateralise financial intermediation raises commercial concerns around its effect on the availability and pricing of liquid assets and on the economic viability of existing trading models. Further, given the ever decreasing pool of risk-free liquid assets available, concerns also exist as to the additional credit and residual risks for financial institutions associated with mandated holdings of liquid assets.

# Securitisation

For originators of traditional bank lending products such as residential mortgages, SME loans, credit cards and consumer and auto finance, securitisation is likely to remain an important part of their funding strategy. Costs of lending are going up and demand for off-balance sheet structures are likely to increase.

The worst excesses of the securitisation market will of course not return anytime soon - structures at the root of the financial crisis such as the financially engineered CDOs or the originate-to-distribute sub-prime RMBS structures. Further, securities backed by commercial real estate (CMBS) remain difficult to finance, as the uncertainties regarding the underlying value of the commercial real estate properties prevail.

For non-bank financial institutions, securitisation will also remain a valuable funding tool. Thinly capitalised equity will need to raise funding and with more restricted funding from banks, funding will increasingly have to be sourced in the capital markets. Securitisation provides a platform for funding which is readily understood despite the financial crisis.

The securitisation industry has worked hard to adopt what are generally considered sensible reforms around "skin in the game" and transparency rules and this is expected over time to result in increasing investor confidence in the market. Regulators have recognised the benefits that securitisation can bring and have tailored new regulatory initiatives to ensure that securitisation remains a viable funding source.

It is interesting to note that throughout the financial crisis access to central bank liquidity was predicated on providing high quality liquid collateral such as securitisations. Indeed many banks have securitised their illiquid pools of assets to ensure they have eligible collateral. Increasingly strict liquidity rules imposed under the new Basel III framework are likely to entrench this trend. Additionally many banks have now made the necessary investments in IT and other systems to establish securitisation platforms so an historic ambivalence to this source of funding because of its perceived complexity and disruption will no longer act as a hurdle to the use of securitisation as a funding tool.

This is not to say there will not be hiccups along the way to the rejuvenation of this market. The uncertain impact of new regulations (for example relating to the swaps markets and fund structures) and the knock-on consequences for securitisation structures will need to be managed. In the past these regulatory changes have, however, not generally proved to be an impediment to issuance. The biggest issue is economic factors. There is still a mismatch between investor and issuer expectations of yield. Moreover, credit institution issuers are entering the market less frequently, in part because they are in the process of deleveraging, and in part because they are able to access cheap central bank funding (such as the Bank of England's Funding for Lending Scheme). The recessionary environment is also affecting issuance, as it results in less origination and therefore less assets to securitise.

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# Repos and securities lending

The Financial Stability Board's recent "Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos" made clear the vital role that these instruments play in the market:

"Securities lending and repo markets play crucial roles in supporting price discovery and secondary market liquidity for a variety of securities issued by both public and private agents. They are central to financial intermediaries' abilities to make markets, and facilitate the implementation of various investment, risk management, and collateral management strategies. Repo markets are also instrumental in monetary refinancing operations in many jurisdictions."

In pointing out some of the risks associated with these products the FSB has also made sensible recommendations, such as improving the reporting by fund managers to end-investors on how their securities are being used.

But there are real concerns about the practical implications of some of the regulatory recommendations. Of particular concern are the proposals covering minimum haircuts, minimum standards for cash collateral reinvestment and public disclosure requirements for financial institutions' securities lending, repo and wider collateral management activities.

Taken together, the recommendations, if adopted, would make the repo and securities lending markets far less flexible and far more costly, making them far less viable as sources of funding.

Minimum haircuts run the risk of interfering with the efficient pricing of these instruments in the market by arbitrarily dictating a minimum price. To the extent minimum haircuts increase the cost of executing repos, they may also indirectly increase the cost of clearing OTC derivatives transactions, which will separately be mandated or incentivised by other regulation (see discussion above) because certain entities will need to use repos in order to convert available collateral assets into a form acceptable to clearing houses. There is a concern that the combined cost of complying with the new requirements could leave some institutions to decide not to implement legitimate hedging strategies, thereby increasing risk in the system.

Minimum standards for cash collateral reinvestment could have the effect of producing government edicts on what institutions can and cannot spend their money on. Given that repos are secured against real assets where the legal title has been transferred to the counterparty, the money they receive in return is their money to do with as they wish. It is potentially concerning to dictate what institutions can spend their own money on and how they might "ring-fence" elements of their balance sheet. While parameters may be sensible in the context of fund managers who are looking after the assets of others, this becomes far more challenging in relation to the balance sheet of a bank or broker.

While disclosure to regulatory bodies and, in the context of fund manager use of fund assets, their investors is a sensible approach, the idea of making public the extent of all entities' repo and securities lending could be highly destabilising. How the data is interpreted, or quite possibly misunderstood, may lead to the sorts of runs on institutions that the FSB policy framework is predicated on avoiding.

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