EUROPEAN ASSOCIATION
OF CORPORATE TREASURERS

What does the real economy[1] need from financial reform?

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The European Association of Corporate Treasurers (EACT)

The EACT is a grouping of national associations representing treasury and finance professionals in 18 countries of the European Union. We bring together about 12,000 members representing 6,500 groups/companies located in the EU. We comment to the European authorities, national governments, regulators and standard-setters on issues faced by treasury and finance professionals across Europe.

We seek to encourage the profession of treasury, corporate finance and risk management, promoting the value of treasury skills through best practice and education.

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Overview

In this paper we seek to provide a brief overview on how the non-financial sector (industrial and commercial firms) and in particular corporate treasurers have been impacted by financial regulation in the recent years. We go on to consider the priorities for the new legislature.

In the past years the focus of financial reform has predominantly been on ensuring the stability of the financial system. This was of course essential. But there has been a fundamental failure to understand and take account of financial regulation's impact beyond the financial system. This impact comes not just from implementation of regulations but the consequential change in behaviour of the affected institutions.

The consequences of this have been felt in the wider economy. They affect employment, investment and growth. It is important that the new legislature takes the

[1] We use the term 'real economy' to distinguish the providers of goods and services in both the private and the public sectors (the real economy) from participants in the financial sector such as banks, investment managers and exchanges.

opportunity to shift EU financial regulation on from the essential stabilisation of the financial system. Regulation must be well adapted to support the growth agenda. Balanced and well-calibrated financial regulation recognising its real world consequences is vital. In this document we therefore address:

- how the previous legislature's financial regulation has impacted the real economy
- changes that will improve the quality of financial regulation by better recognising end-user impacts
- our priorities for the 2014-2019 legislature

Impact of financial regulation on non-financial companies

Non-financial companies depend on the financial system to provide essential services for conducting their business. These can vary from deposit-taking, payment services, working capital finance, risk management services, provision of debt finance, assistance with access to other markets, investing excess cash and advisory services across the whole range of financial management. Therefore the non-financial sector has been both directly and indirectly impacted by the regulatory changes that have and are still taking place in financial services. Examples of this are described in the following paragraphs.

In terms of access to and conditions for financing ***the new bank capital framework of Basel III / CRD IV*** has made bank financing more restricted and costly, which is true both generally and in particular for SMEs. The effect will increase as the implementation of the capital rules moves forward. As a consequence there is growing pressure on non-financial companies to seek funding from other sources, such as capital markets and private equity. Whilst broader and deeper financial markets are good for funding this new pressure has increased risk and uncertainty at a time when stabilisation – to create the growth platform – is so important as a shared policy objective. Growth, investment and job creation projects are harder for firms to justify when future finance for the firms and their customers and suppliers may be doubtful.

A key responsibility for treasurers and other financial managers in non-financial companies is to reduce risk to their firms arising from exposures to currencies and interest rates. In doing this, their companies have found themselves brought directly into the scope of financial regulation, in particular by ***the European Market Infrastructure Regulation (EMIR)***. EMIR deals with clearing, reporting and risk mitigation obligations for OTC derivatives (the instruments needed to manage risk) and extends certain obligations to all non-financial companies regardless of their individual size and their volume of activity. This sucking in to financial regulation of non-financial customers of the financial services industry is perverse. This is especially so as non-financial companies collectively represent a tiny proportion of these markets and inter-connectedness among non-financials is far, far less than among financial firms.

The EACT is grateful that the EU legislators eventually recognised that corporate hedging transactions should not be subject to central clearing or CVA charges under EMIR and CRD IV – CRR. However, the obligations for non-financial companies - for instance to report all OTC derivative transactions to a trade repository - are extremely burdensome and have little or no relevance in terms of supporting financial stability. It also remains to be seen how different financial reforms will impact the overall market for and prices and availability of derivatives and therefore also non-financial companies' hedging strategies. If companies were to be pushed to reduce their hedging volumes or stop hedging altogether, their operational risks would materially increase. This outcome will inevitably threaten financial stability, employment and growth as well as directly increasing risk for their lending banks.

Non-financial companies' cash management is also being impacted by many regulatory changes. In the past years the implementation of the Single Euro Payments Area (SEPA) has demanded substantial resources and investment. At the same time the Basel III/CRD IV liquidity rules are likely to make corporate cash deposits less attractive for banks because other liabilities, such as retail deposits, receive a more favourable treatment under the new rules. At the same time from corporate perspective bank deposits will become more risky as the new EU bail-in framework will also make corporate deposits (wholesale deposits) more risky because of the exposure to losses in a new banking crisis.

The accumulation of all the post-crisis financial regulation since 2008 brings with it – in implementation – a real risk of inconsistent outcomes and unintended consequences. It is important therefore to look critically at the case for each incremental piece of new regulation.

It should also be noted that the impact and cost of regulatory change is amplified for companies operating internationally faced with inconsistent rules globally. Coherence and consistency of regulation at G20 level should be one of the main objectives of the legislator.

How the Parliament and the Commission can better recognise end-user impacts

Better regulation will be one of the key concerns of the next Commission – we believe that in terms of financial regulation this should translate into recognition and minimisation of the impact on end-users. We consider that the following changes are needed:

- ***Assessment of the impact of legislative measures on the real economy and early engagement*** between policy-makers, legislators and representatives of non-financial companies. Corporate treasurers deal with financial institutions, products and services on a daily basis and their voice should be heard when these are being regulated – because changes in the financial system also have fundamental impacts on the users. The impacts on end-users of financial services can be hard to perceive in advance as they are at the end of the financial industry's implementations of regulations and the financial firms' behavioural adaptations. Rushed consultations add greatly to the risks.

- ***Non-financial companies should not be assumed by default to be the same as financial companies*** when financial regulation is being developed. At the very least companies in the real economy do not have the same systemic importance. Imposing financial sector obligations on non-financial companies is neither meaningful nor appropriate.
  The compliance burden for such non-added value activity is considerable and legislators need to consider carefully whether the legislation has any relevance to the reduction of systemic risk or increase in financial stability. Non-financial companies use financial products to support their business activities rather than to 'trade'. This benefits the wider economy, growth and employment through for instance price stability and reduced volatility in company performance. Importantly it reduces the risk allowances involved in assessing investment and growth projects for firms – reducing business conservatism and encouraging growth in the economy.
- There should be ***a more structured and sustained dialogue with non-financial companies – and in general, the real economy***. This could be done by more effective and timely consultation with representatives of non-financial companies and in general organisations other than those lobbying for the interests of the financial sector. There is also an urgent and continuing need for a more balanced composition of stakeholder groups such as the ESMA Securities and Markets Stakeholder Group (SMSG) – where there is currently no non-financial company representative.
- ***Flexibility should be built in to legislation where possible and appropriate***, so that modifications after experience is gained are relatively easily achieved and not grand projects themselves. The consequences of financial regulation for end-users are hard to predict and may emerge only after rules come into effect, sometimes being realised only later in economic cycles.

Our priorities for the 2014-2019 legislature

The new legislature will deal with a number of current regulatory files proposed by the Commission. Our major concerns on these are the following:

- **Banking structural reform:** the services that are needed and provide real value to the real economy should not be separated to a trading unit – this is particularly true for OTC derivatives used for hedging purposes by non-financial companies and market-making needed to provide liquidity for corporate bonds and equity. EU policy-makers are increasingly calling upon the capital markets to fill the lending gap but at the same time treating market-making – a necessary activity for a well functioning capital market – in a punitive manner. The EU must adopt a coherent and consistent strategy in terms of future funding markets.

- **Financial Transaction Tax:** we have from the beginning consistently argued that the FTT would be a tax on the real economy – individuals, pension funds and industrial and commercial companies. As such it would cause serious damage to all users of financial services, by directly and indirectly burdening them with additional costs. Our view is that the FTT proposal should be abandoned.
- **Money Market Fund Regulation:** MMFs are an important cash management tool and are buyers of short-term commercial paper. For non-financial companies it is important that the continued existence of both Constant Net Asset Value (CNAV) and Variable Net Asset Value (VNAV) funds is ensured. Any implementation of a ban on ratings of MMFs would effectively destroy the market for all those (other than banks) who rely on the provision of sound ratings to guide investment. The combination of the threats to MMFs contained within the proposed Regulation would, if implemented, perversely lead to an increase in systemic financial risk, as a result of a forced concentration of liquidity in a small number of well rated 'national champion' banks.
- **Review of EMIR:** the burden on non-financial companies that use OTC derivatives to hedge their underlying commercial and financial risks should be considerably reduced and simplified, for instance by allowing one-sided reporting (reporting only by financial institutions), exempting intra-group transactions from the reporting obligation and minimising the portfolio reconciliation requirements.

We very much look forward to the chance to engage with the new legislature and to amplify the issues and concerns expressed in this document.

The European Association of Corporate Treasurers

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