G-20 AND THE REAL ECONOMY: Bridging the Divide

B20 BUSINESS

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Foreword

In response to a question regarding whether anyone has studied the cumulative effect of the financial reforms and the impact of these reforms on credit availability and economic recovery– U.S. Federal Reserve Chairman Ben Bernanke stated, "I can't pretend that anybody really has. It's just too complicated."

The financial crisis that first rocked advanced economies in 2007, and whose aftershocks continue to reverberate around the world, mobilized G-20 policy makers to devise new rules aimed at mitigating risk in the global economy. It also led many businesses to seek new business models and recalibrate investment decisions in light of the expected shifts in the policy environment in all major markets. Concerned entrepreneurs around the world welcomed G-20's resolve to create a more resilient global financial architecture. However, while each new policy tries to address specific risks and perceived market vulnerabilities, the convergence of the new regulations on the non-banking sector is akin to experiencing a very long and drawn out earthquake, where the familiar ground of running a business is constantly shifting. Indeed, the two responses to the crisis – one by wealth creators and the other by wealth regulators – have not been in sync.

In recognition of this growing divergence, business federations across the G-20 countries redoubled their efforts to integrate business perspectives in G-20 policy-making processes. Our efforts are beginning to meet with some success. Although companies realize that final regulations and policies will be imperfect, the worst case scenarios feared by many companies are now less likely – at least by government mandate. However, conflicts continue to arise between and among various G-20 inspired reforms which may leave companies effectively choosing between two or more evils.

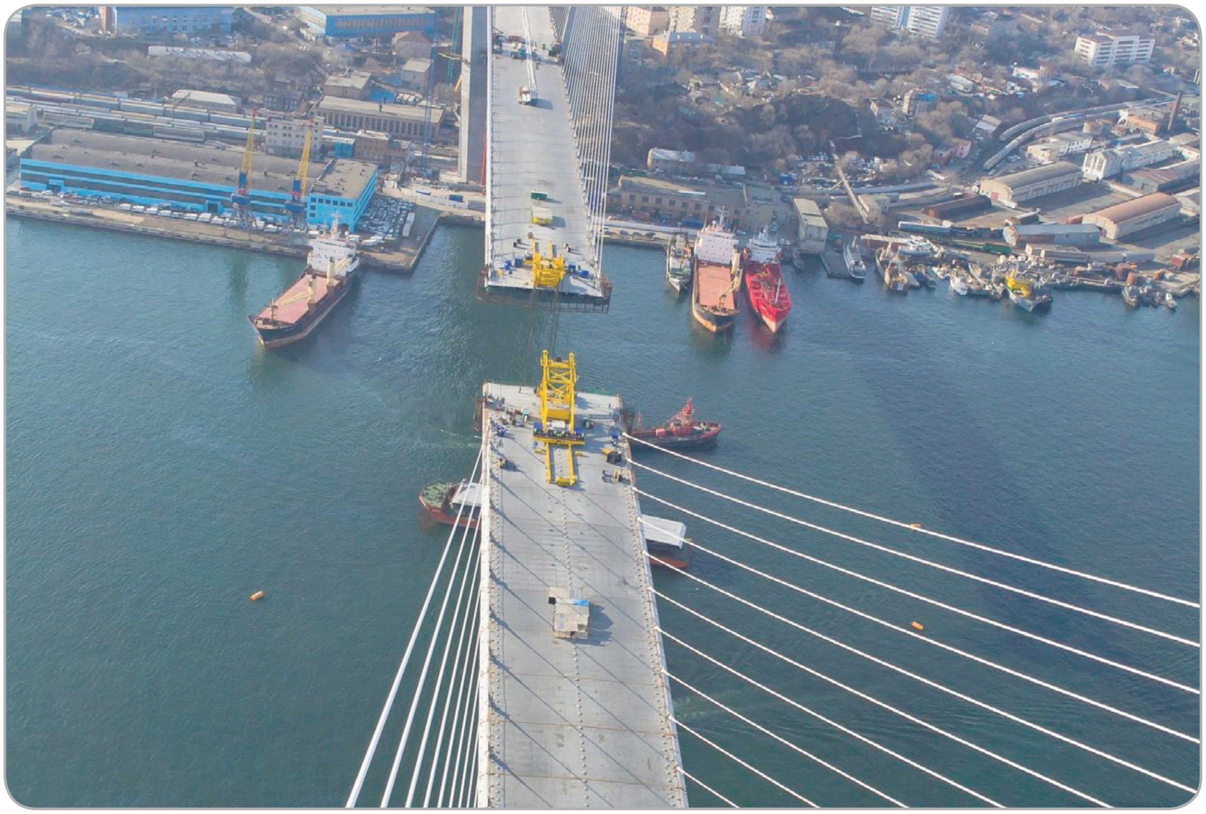
This booklet attempts to bridge the gap between the world as envisioned by shell-shocked regulators and that experienced by companies in major markets. By tapping into the membership and insights of the most representative business federations across the G-20 countries, our goal is to draw policy-makers' attention to how their decisions affect the ways in which businesses compete, invest, grow or fail.

Any further divergence between political expectations, regulatory responses, and the reality of creating jobs, executing on business vision, and delivering value in goods and services will crimp growth prospects in G-20 economies. The business community recognizes its responsibility to let policy makers peer into their world; a world characterized by the pressure of the markets, an unwavering ambition to compete globally, and the daily struggle to generate economic growth.

Here, companies from around the G-20 countries provide a snapshot of some of the potential effects of the regulatory response and shed light on how to answer the following questions:

- Are there differences in the way the regulations are perceived by business in various G-20 markets?
- Could the new regulations add to economic volatility by limiting the way companies manage risk?
- Could the regulations create new business opportunities?
- Could they force companies to set aside cash that would otherwise be used for productive investments?
- Could the regulations create incentives for companies to move their business operations to new locations?

We hope the same questions will anchor the agenda of forthcoming G-20 meetings, and be the foundation of the dialogue between political leaders, regulators and job-creators.



Bridge Over Troubled Waters: G-20 Inspired Financial Market Reforms

In 2009, the G-20 was designated the premier forum for international economic cooperation and tasked with creating a new and more resilient global financial architecture. Since then, their efforts have been principally aimed at achieving regulatory reforms that strengthen oversight and change the behavior of financial sector participants.

According to the Financial Stability Board (FSB)[i] , the G-20 regulatory reform agenda covers a broad range of topics at different stages of policy development and implementation. The agenda includes, among others, policy measures to improve the soundness of the banking system, including the Basel III capital and liquidity framework; reduce the moral hazard posed by systemically important financial institutions via better resolution regimes, more intensive supervision, and the strengthening of core financial market infrastructures; expand and refine the regulatory perimeter, including the regulation and oversight of the shadow banking system; improve OTC derivatives and commodities markets; develop macro-prudential frameworks and tools; strengthen and converge accounting standards; strengthen adherence to international financial standards; reduce reliance on credit rating agency ratings; and strengthen consumer protection frameworks to promote financial stability. Several reforms directly shift the grounds of business risk management outside the financial sector with implications for investment decisions at both national and global levels.

Of the internationally agreed regulatory reforms, businesses in both developed and developing G-20 economies are already experiencing the impact of changes in bank capital and liquidity standards, and OTC derivatives market reforms. The OTC derivatives market reforms aim to improve transparency in OTC derivatives markets, mitigate systemic risk, and protect against market abuse. Implementation of OTC derivatives market reforms is ongoing and there are several outstanding issues under discussion including the scope and application of central clearing requirements and exemptions; regulation of market infrastructures; central counterparty (CCP) location requirements; frameworks for organized platform trading; transparency requirements; the nature of reporting and access to trade repositories; and capital and margining requirements for non-centrally-cleared vs. centrally-cleared contracts.

Respondents in a recent FSB study identified several consequences that could arise, particularly due to the global scope of the G-20 reforms. For example, any comprehensive regulatory framework – such as the ones being developed by the U.S. and EU – will have cross-border impacts raising the possibility of significant jurisdictional inconsistencies. In addition, the complexity of the Basel III rules could negatively affect certain types of banking activities (e.g. trade and project finance), the development and functioning of capital markets in developing economies and lead to overall increases in the cost of capital or the lending capacity of banks.

As noted by the Chairman of the FSB, "confidence remains fragile, creating headwinds for growth as well as reforms." The question is "…is financial reform part of the problem? Or part of the solution?"[ii]

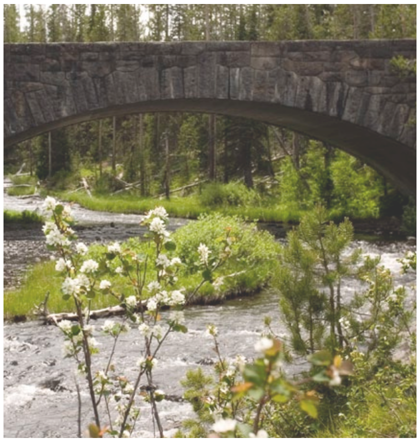
Progress in Implementing G-20 Recommendations on Financial Regulatory Reform[iii]

G-20 Recommendations	Status
Improving Bank Capital & Liquidity Standards: Basel III, Basel II & Basel II.5	Some jurisdictions unlikely to meet the agreed 1 Jan. 2013 Basel III implementation date. There is a possibility that national implementation will be weaker than the globally-agreed standards in some key areas. Adjustments to the Liquidity Coverage Ratio to be completed by end-2012.
	20 of 27 BCBS member countries have implemented Basel II.5. Some major G20 financial centers have not implemented the Basel II framework and among the 29 global systemically important banks (G-SIBs) identified in November 2011, nine are headquartered in jurisdictions that have not yet fully implemented Basel II or Basel II.5.
Ending "Too-Big-To-Fail"	National authorities are in the process of developing and implementing measures for G-SIFIs (Global-Systemically Important Financial Institutions). Progress is being made in national legislative reforms to establish more effective resolution regimes. Although crisis management groups have been established and progress is being made, much further work on resolution plans and on cross-border co-operation is needed to improve resolvability.
Expanding and Refining the Regulatory Perimeter: Shadow Banking System	National authorities are still facing challenges in collecting appropriate data to assess the trends and risks especially with regard to non-bank financial entities.
Creating Continuous Core Markets: OTC Derivatives Reform	Progress has been made by a number of jurisdictions and by international standard setting bodies. Four safeguards for a global framework of CCPs have been established to help create a resilient and efficient environment for global clearing. Considerable further work is needed in many jurisdictions to fully meet the G20 objectives. Close cooperation across major markets will be needed to address overlapping regulations.
	Few jurisdictions have the legal and regulatory framework in place to operationalize G20 commitments with regard to regulation, functioning and transparency of commodity derivative markets.
Creating Continuous Core Markets: Strengthening & Converging Accounting Standards	Improvements have been made in some areas (e.g. fair value measurement, disclosure of off-balance sheet exposures, and disclosure of offsetting/ netting) but work is continuing in other areas (e.g. financial instruments classification and measurement, impairment and hedge accounting).
Creating Continuous Core Markets: Global Legal Entity Identifiers & Credit Rating Agencies	Some SSBs and a few national authorities have taken steps to reduce reliance on CRA ratings. However, overall progress has been modest. Efforts to develop alternative risk assessment capabilities and processes need to be reinforced.
Developing Macro-prudential Frameworks and Tools	Progress is being made, but national policy frameworks and data have yet to be developed in many jurisdictions.
Strengthening Adherence to International Supervisory and Regulatory Standards	Almost all FSB member jurisdictions have now completed the implementation of the FSB Principles and Standards in their national regulation or supervisory guidance. The Bilateral Complaint Handling Process and an ongoing monitoring framework have been established to promote full and consistent implementation. Further progress is needed in areas such as implementation of claw-backs and the identification of material risk takers.
Strengthening of Financial Stability Board	Ongoing.
Identify Unintended Consequences of Regulatory Reforms on Emerging Market and Developing Economies and Provide Capacity Building Where Required	Initial study completed. Further assessment needed in some areas.

Based on FSB Status Report dated June 19, 2012

Unexpected and Unintended: Adding to the Cost of U.S. Exports

Pennsylvania–USA



FMC Corporation is the world's largest producer of natural soda ash, the principal input in glass manufacturing. FMC mines and refines soda ash products in southwestern Wyoming, ships them to South Asia, and delivers them at a lower cost and with higher quality than many international competitors. One of the key ingredients in FMC's success as a competitive exporter is its tireless attention to managing basic business risks faced every day by employing financial derivatives.

Energy is a significant cost element in producing soda ash and FMC protects against unpredictable fluctuations in future energy costs with OTC derivatives to hedge natural gas prices. These derivatives are done with several banks, all of which are also supporting FMC through their provision of almost $1 billion of credit. Our banks do not require FMC to post cash margin to secure mark-to-market fluctuations in the value of derivatives, but instead price the overall transaction to take this risk into account. This structure gives us certainty so that we never have to post cash margin while the derivative is outstanding.

However, if we are required by the regulators to post margin, we will have to hold aside cash and readily available credit to meet those margin calls. Because failure to meet a margin call would be like bouncing a check, and would constitute a default, our corporate treasury would act very conservatively in holding cash or immediately available funds under our bank lines of credit to assure we could meet any future margin call in a timely fashion and with a comfortable cushion. The reality treasurers face is that the money to margin derivatives has to come from somewhere and inevitably less funding will be available to operate their businesses.

Furthermore, the cumulative effect of the new financial regulations could mean that U.S.-based manufacturers with substantial exports could no longer economically hedge their foreign exchange risk with derivatives. As a result they could be forced to move production offshore to match their costs directly with the currencies of their customers.

Based on Testimony of Thomas C. Deas, Jr., Vice President and Treasurer, FMC Corporation, Hearing before the Senate Committee on Banking, Housing, and Urban Affairs, April 12, 2011. FMC Corporation manufactures and markets a range of agricultural, specialty and industrial chemicals.

FMC and other members of the U.S. Chamber of Commerce and the Business Roundtable estimated that member companies would have to hold aside, on average, $269 million in cash or immediately available bank credit to meet margin calls. In our world of finite limits and financial constraints, this is a direct dollar-for-dollar subtraction from funds that we would otherwise use to expand our plants, build inventory to support higher sales, undertake research and development activities, and ultimately sustain and grow jobs. In fact, the study extrapolated the effects across the S&P 500, of which FMC is also a member, to predict the consequent loss of 100,000 to 120,000 jobs.

—FMC Corporation

A trio of post-crisis reforms – the Basel III liquidity coverage ratio, central clearing for standardized derivatives and nascent global standards on margin for uncleared trades – could create combined demand for $7 trillion of collateral according to some estimates. "…[T]here is no doubt these rules taken together will cause a collateral shock. The competing demands will inevitably cause collateral to become an increasingly scarce and expensive commodity," according to Peter Sime, head of risk and research at the International Swaps and Derivatives Association in London.

—Matt Cameron, "New Regulations Could Cause $7 Trillion 'Collateral Shock'", Risk Magazine, online-version, April 11, 2012.

Dutch Pensioners to Pay Up

Amsterdam–The Netherlands

Netherlands-based asset manager APG Algemene Pensioengroep N.V. (APG) is the asset manager of multiple Dutch pension funds including the largest pension funds in all G20 countries. Due to its scale and the variety of assets under management (equity, fixed income and alternative investments – derivatives are used for hedging purposes only), APG and the investment vehicles it manages are the subject of many of the newly proposed financial markets regulations.

The views of APG when responding to such draft legislation are primarily driven by: (i) the interests of the ultimate beneficiaries of the investment proceeds, i.e. the pensioners and (ii) the fact that Dutch pension funds are very solvent, conservative, stable and long-term investors.

The following example illustrates how one of the newly proposed EU regulations – the mandatory clearing of OTC-derivatives (EMIR) – affects Dutch pension funds. Though the aim of this legislation is to protect end-users such as pensioners by reducing systemic risk, in this case the original proposals would have resulted in severe costs for - ultimately- these same pensioners. As pension funds and their investment vehicles actually pose the least systemic risks to the financial markets in this context, APG was involved in the process of lobbying for an exemption from mandatory clearing for such entities. This exemption has now indeed been granted (albeit in a temporary form) which, based on an internal cost impact analysis, may have saved the pensioners served by APG up to (at least) several hundreds of millions of euros/dollars. This example serves to illustrate the quantitative impact that newly proposed measures may have at the actual end-user level, i.e. pensioners with an average monthly benefit of less than €1,000.

While APG strongly supports creating further stability in the financial markets and welcomes every measure protecting end-users, new legislative proposals should be accompanied by diligently prepared impact analyses enabling politicians to weigh all consequences. It is also vital that policy makers consider the proportionality of the proposed measures and take into account the particular characteristics, drivers and business models of the various market parties subject to the newly proposed regulations. The level of actual contribution to systemic and/or credit risk relative to the level of imposed costs and tied up capital are very relevant factors to take into account, every single time.

APG is an indirect subsidiary of Stichting Pensioenfonds ABP, the Dutch pension fund for the government and education sectors and the third largest pension fund globally. APG works for more than 20,000 employers and provides for the income of more than 4.5 million Dutch citizens managing over 30% of all collective pensions in the Netherlands.

Both U.S. and European regulators want to clamp down on the use of the complex financial instruments, whose values are tied to the performance of an underlying security or benchmark. … Many companies buy basic types of derivatives to protect their earnings against fluctuations in interest rates, commodity prices, or currencies—a process known as hedging. … American Airlines, for instance, controls its fuel costs with derivatives. Packaged goods maker Kraft Foods uses them to keep grain expenses in check. … Exchange-based derivatives cut into cash reserves. … Companies that use [exchange-based] derivatives would have less money to invest in their operations. European manufacturing giant Siemens reckons it will need an extra $1 billion in cash reserves, and engine maker Rolls Royce figures its tab would total $4 billion. … Furthermore, "Any reduction in the access to non-standardized derivatives would… add volatility and risk to quarterly earnings," Michael W. Connolly, Tiffany's treasurer, told Congress. The jeweler uses derivatives to manage the cost of silver and other metals. Businesses are rethinking their strategies in response to the proposed rules.

—Ben Levisohn and Mark Scott, "The Side Effects of Financial Reform", BusinessWeek, October 7, 2009.

How to Benefit from Australian Exposure in Illinois

According to a 2011 Coalition for Derivatives End-Users survey, a 3 percent initial margin requirement, assuming no exemptions, would require average collateral of $192 million per respondent company. At Caterpillar, we have much more productive potential uses for that capital—such as investing in our production facilities to meet rapidly growing demand for our product.

Illinois–USA

Understanding and managing risk is key to successfully operating a business. At Caterpillar, we can control internal risk factors linked to the way our factories are designed, and the velocity with which we transform input materials into assembled product. We can't, however, control many external factors like the global price of copper, fluctuation in the value of the Japanese yen, or the movement of interest rates in key economies. We mitigate these risks by hedging our net exposures with derivative contracts after taking advantage of any offsetting positions.

As an example, we sell a large quantity of mining truck replacement parts manufactured in Decatur, Illinois to our dealers in Australia. We pay the costs associated with the production of Decatur parts in U.S. dollars. When we sell those parts, we receive revenues in Australian dollars. The relative value of the Australian dollar versus the U.S. dollar can significantly impact the economic viability of these types of transactions. To manage the risk, we may enter into a forward contract with a bank counterparty to sell a certain amount of Australian dollars, equal to our net exposure, on a certain date to lock in the current market forward rate. We enter into similar hedging transactions to limit our risk exposure to the cost of key input commodities, like copper, as well as to interest rates.

Also, during the crisis, organizations like Caterpillar Financial Services brought an additional source of liquidity to small and medium-sized businesses. In order to facilitate the sale of the parent's manufactured goods, captive finance affiliates often finance the sale or lease of products that are intimately connected to the underlying product. Examples include the financing of an implement or accessory to a tractor, the purchase of a used tractor to facilitate the sale of a new one, or the financing of a marine vessel to facilitate the sale of Caterpillar engines. In each of these examples, the financing offered by the captive finance unit is essential to facilitating the sale of their parent or affiliate's manufactured goods.

Based on Testimony of Jill Harlan, Corporate Risk Manager, Caterpillar, Inc., Hearing before the Senate Committee on Agriculture, Nutrition, and Forestry, March 3, 2011. Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines, industrial gas turbines and diesel-electric locomotives.

Many of our members are facing cash-flow problems due to (very) late payments by their large contractors. As micro-businesses sometimes run their businesses based on a handful of large clients, one late payment may cause serious problems in terms of equity. Prior to the crisis, a short-term bank loan would be a solution to bridge this gap. However, getting a bank loan has become close to impossible for most small businesses. Basel III - resulting in the CRD IV directive - which tells banks to retain more liquidity, will only worsen this situation as bank loans will become more expensive or in the worst case unattainable.

—Patrick Gibbels, Brussels Representative, European Small Business Alliance, Euractiv, December 23, 2011.

Can G-20 Spur Financial Inclusion in the Wake of Financial Crisis?

Mumbai–India

In discussing the impact of the G-20 reforms, Mr. Bharat Doshi, Executive Director & Group Chief Financial Officer of Mahindra & Mahindra (M&M) noted that "Indian companies seeking banking/debt facilities in Indian currency will tend to be less affected as Indian banks are well placed in terms of capital and liquidity. Overall, for Indian banks, the transition to Basel III will be incremental, not a complete makeover."

In a larger sense, however, Indian corporates, including Mahindras, may face reduced availability of cross-border funds, whether loans, trade credit, or OTC derivatives from international banks because of new calibrated risk weighting and credit value adjustments. International banks will reduce credit availability to adhere to capital requirements and/or increase pricing as they race to shore up capital. Also, while the fall out in India's domestic financial services sector is not likely to be significant, the overall regulations on capital, liquidity and other general provisions could reduce cost-effective external commercial borrowings into India.

While Mr. Doshi believes that the G-20 financial reforms will not have a direct or substantial impact on M&M, "the entire financial system will face the collateral impact of availability of capital and its cost. One of the knock-on effects could be from overseas companies of Indian business houses, whose reduced access to funding will convert into a demand on the Indian parent's financial resources. Again, where there are global supplies, the implementation of these regulations would have a cascading impact on costs."

Mr. Doshi further highlights the importance of safeguarding the interests of the developing economies. While in some advanced economies the financial services sector has been downsizing and deleveraging, in India and other fast dynamic developing countries there is an acute need for much deeper capital markets, as well as broader provision and innovation of financial services. "The new norms have been framed to safeguard the global financial system's long-term stability in view of its interconnectedness. However, there should be ways of supporting economic growth in the developing world, which suffers from low financial penetration levels and availability of banking services. Institutional support for accessing affordable cross-border credit and concessions in risk weighting for developing world credit should be made possible in order to make the transition less painful. The fine balance is how to encourage a movement towards an orderly financial system without impinging on genuine credit requirements of countries that depend on credit penetration to alleviate poverty?"

Mahindra & Mahindra is one of the leading diversified groups in India with operations spanning across 18 industries – from aerospace and construction equipment to energy and information technology.

The reduction of banking activity in areas like trade credit, derivatives and the cash collateral requirement for CCPs could impact international trade and the availability and cost of risk management, having implications for Indian corporate operations and profitability. It may be remembered that during the financial crisis of 2008/09, trade credit was one of the key reasons for global trade faltering.

—Mahindra & Mahindra

The Growing Price of Global Engagement

Wolfsburg–Germany

In the highly competitive globalized world that we live in today, companies must be prepared and committed to investing in new technologies, new plants and new markets. This is particularly true in the automotive sector where competition for new markets and new customers is fierce. Since its inception in the 1940s, Volkswagen has committed itself to consistent innovation and improvement.

With 94 production plants in 26 countries and sales in 153 countries, Volkswagen Group must manage the risks associated with foreign exchange and materials purchases. The purpose of using derivatives to actively manage this risk is to anticipate the relative changes in currencies and the price of inputs and lessen the impact of fluctuations on earnings and value.

While we support measures that increase transparency and add stability to the banking system, we are concerned that the new regulations inspired by G-20 commitments such as EMIR in Europe and the Dodd-Frank Act in the United States, could force us to post margin when we use derivatives to lower our business risk. 'Posting margin' essentially means that we will have to tie up our financial resources in non-productive accounts meaning less money to invest in, for example, research into new technologies. From our research labs in California and China to our new high-voltage battery project house in Gaimersheim, Germany, we understand that the technological challenges of the future can only be mastered by intensive research and development. This, of course, takes money.

In addition, complying with many of the new regulations will require investing in new systems and processes. While this will also place a burden on our liquidity, we are prepared to make the necessary investments as we believe that it will add to transparency in the long run. Global engagement will now come at a much higher price. All in all, with regard to the new financial regulations, we hope to be able to continue to safely manage our business risks, optimize our working capital and plan for the future.

Headquartered in Wolfsburg, Germany, the Volkswagen Group is one of the world's leading automobile manufacturers and the largest carmaker in Europe.

Following the adoption of the International Labor Organization's (ILO) Global Jobs Pact in June 2009, we have seen very positive steps taken by the G-20 in ensuring that we have a better functioning, post-synchronized crisis world. Further, the historic joint statement signed by the B20, L20 and G-20 in Cannes was a very significant step in demonstrating commitment and coordination that will create sustainable enterprises and concomitantly, sustainable jobs. We must guard against spending too much time on rhetoric though and implement coherent policies that will deliver employment, especially for the youth. We look forward to making more progress in Mexico and in Russia when the coordinating role moves to same with increased vigour. Finally, we should not lose sight of the critical role that must be played by emerging economies to ensure that their projected economic growth is leveraged by all in order to achieve a fair global economy.

—Mthunzi Mdwaba, Chairman & CEO of Tzoro Industries, Member of the B20, Vice President of BUSA, Member of the Governing Body of the ILO & Management Board Member of the IOE

On Coils, Cans and Trading Counterparties

Diverting more than $400 million of working capital into margin accounts would have a direct and adverse impact on our ability to grow our business and create and maintain jobs. In short, margin requirements will cost the communities in which we are located literally hundreds of good, new jobs.

Colorado–USA

Colorado-based Ball Corporation believes that the prudent use of derivatives by manufacturers provides a critical risk management tool which reduces commercial risk and volatility in normal business operations.

Ball's largest business (beverage can manufacturing) involves buying over $3 billion of aluminum coils per year, converting those coils into cans and selling them to large beverage and food companies. As aluminum is an actively traded commodity, we are able to use OTC swaps to exactly match the prices and timing of when we buy coils to when we sell the completed cans. Not executing the swaps would create more volatility in our business outcomes.

In addition to the concern over added business volatility, aspects of the new financial regulations, in particular the requirement to post margin, could have a serious impact on our ability to invest in and grow our business. For example, Ball Corporation is currently investing significant amounts of capital in plant expansions in Texas, Indiana, California and Colorado. These expansions alone add up to over $150 million in investments and will add several hundred jobs when complete. Tying up capital for initial and variation margin could put those types of projects at risk. The impact of posting initial margin for us can easily exceed $100 million, while the change in value on our trades over time could easily surpass $300 million in required capital that would be removed from productive economic use.

Overall, creating rigid and expensive trading requirements could lead to other unintended consequences – companies might be forced to either retain more risk or seek risk management alternatives overseas. New margin requirements for end-users like ourselves or excessive capital requirements applied to our financial counterparties could actually increase systemic risk and push transactions off shore.

Based on testimony of Scott Morrison, Senior Vice President and CFO, Ball Corporation before House Subcommittee on Agriculture, February 10, 2011.
Ball Corporation is a 131-year old publicly traded company which supplies packaging to the food, beverage and consumer product industries.

"Indian banks are well capitalized and there is not much concern in complying with the Basel III norms. However, given the condition of European and U.S. banks, there is a fear of a liquidity crunch once they are required to comply with the norms. This could severely impact the global supply of funds due to inter-linkages in world economies and can accelerate the slowdown. Indian corporates with global operations could be impacted with lower cross-border credit facilities and may need to re-assess their risk frameworks. So, such regulations on capital and liquidity on global banks could impact developing economies like India which may need external commercial borrowings to finance growth in certain key sectors.

Though there is a need for governments and banks to work in tandem to develop a framework of global policies for long-term financial stability, it is critical to be cognizant that uniform policies may impact developing economies differently. Hence, before implementation of such policies, there is a need to understand their impact on the developing world which is not isolated from the global economy and ensure that growth financing is not compromised."

—Mr. Adi Godrej, President, Confederation of Indian Industry (CII) and Chairman, Godrej Group

Chocolate Spillovers

Istanbul–Turkey

Istanbul-based Yildiz Holding, which is a leader in many markets for chocolate, spices, coffee and other products that bring joy and flavor to life, notes that the liquidity coverage and leverage ratios imposed by Basel III are significantly parallel to those already implemented by the Banking Regulation and Supervision Agency (BRSA) in Turkey. While Yildiz believes that the proposed financial stability regulations will not significantly impact the financial and non-financial sectors in Turkey, there is a risk that the new regulations will bring inflationary pressures to bear on the Turkish economy through economic spillover effects.

Although the current Turkish banking sector already covers most of the requirements of Basel III, the BRSA may respond to the ongoing recession in European markets by further tightening their standards. This certainly has been the case ever since the 2001 Turkish economic crisis. Increased capital adequacy and liquidity coverage ratios may result in limitations on our customers' access to loan facilities and create collection risks for the Group as well as a significant barrier for growth.

In addition to this, increased cash requirements in foreign markets may trigger a need for cash, which would force short-term portfolio outflow from the Turkish financial markets. The increased demand for cash abroad may result in excessive currency losses for Turkish companies, which are heavily exposed to foreign currency risks. In a text-book response to the short-term currency outflow and deterioration of the account deficit, the Turkish Lira would lose value making imports more expensive. Since Yildiz relies on a global supply of food ingredients, our costs would go up. If we are able to reflect these cost increases in our prices, we will be able to sustain our profitability. However, such cost and price increases on food products will ultimately affect inflation rates in the Turkish economy.

All in all, we hope to see speedy decision-making processes in other countries and international regulatory bodies in order to stabilize volatile financial markets and macroeconomic conditions, which are closely related to and quite crucial for our export sales, international businesses and credit risk management in foreign operations.

Yildiz Holding is a Turkish integrated food and beverages group with a workforce of 24,400 and 54 factories, nine of which are in foreign countries.

Increasing capital requirements under Basel III, coupled with rising litigation costs, may lead EU financial institutions to divest non-core businesses. In addition, non-financial companies, which fall under liquidity stress due to limitation in credit lines following Basel III, may become available in the M&A market. This may create opportunities for Turkish companies, having sufficient funding capabilities compared to its European peers.

—Yildiz Holding

"Risk management is crucial to enable airlines to run stable businesses, manage cash-flows and undertake business planning," says Roland Kern, head of treasury at Lufthansa's headquarters in Frankfurt. …European airlines use more than 300 million barrels of jet fuel each year, and the extreme volatility in oil prices since early 2008 has generated $27 billion in cost uncertainty. That means any regulation that makes derivatives harder or more costly to use could be catastrophic for the industry," says Kern. ...Pointing to the decline in the price of crude oil in 2008 from $147 a barrel to $40 a barrel, Kern estimates it would have cost Lufthansa €2 billion–3 billion in cash collateral to hedge such a move through a CCP. "Our industry simply does not have access to this type of liquidity. Collateral obligations would result in an increase in liquidity risk and limit the use of hedging, ultimately increasing risk and possibly threatening the continued existence of some airlines," argues Kern.

—Joel Clark, "Lufthansa Wary of OTC Regulations", Risk Magazine, August 3, 2010.

Increased Compliance Costs for Banks Creates Windfall for Indian IT Giant

New regulations like Basel III present a significant business opportunity for TCS. Across the globe, financial services companies are increasing their IT spending on compliance initiatives such as Basel III, Dodd-Frank etc.

Mumbai–India

When some of the largest companies in the world are busy re-aligning their business strategies, processes and systems to comply with the G-20 financial reforms, Indian IT major Tata Consultancy Services (TCS) sees a silver lining in the development. Mr. A. N. Jayaraman, Head, BFS Risk Management Practice, TCS shared his business perspectives on how the G-20 inspired reforms such as Basel III and OTC derivatives impact the Indian IT giant.

Analyzing the impact of Basel III norms on lending by banks he said, "In the current macro-economic scenario, banks across the world are facing an uphill task in shoring up their capital and liquidity ratios. As a result, banks are expected to restrict lending to sectors which require higher capital and liquidity as per Basel III guidelines. However, TCS has a comfortable capital and liquidity position owing to its prudent internal policies and robust business model. Hence, TCS will not be impacted directly due to reduced lending from banks to the real economy."

On the impact of new requirements in OTC derivative trading on TCS, he said "IT companies use Forex Forwards as the major hedging instrument. Currently, all Forex Forwards are OTC settled. In the future, if the trades have to move to a Central Clearing Counterparty platform, TCS should be able to adopt it easily without any impact on its operations. This opens up opportunities for TCS as well. Banks will have to alter their business model, technology platforms, processes and infrastructure to comply with the new guidelines. TCS with its vast experience in handling large transformation projects is ideally placed to work with our customers in getting things in place for the new world."

In his view, the regulations proposed by the G-20 are essential for the long-term stability of the global economy. "Companies should look at these regulations as an opportunity to improve their business processes, policies and governance thereby deriving strategic benefits in the long run. We are not directly impacted by the new regulations and see it as very positive for the global economy. New regulations may cause disruptions in the short to medium term but are an absolute necessity for long-term stable growth."

TCS is an IT services, business solutions and outsourcing organization. TCS is part of the Tata Group, one of India's largest industrial conglomerates, and employs over 238,583 IT consultants in 42 countries.

A large part of the Danish economy runs on trade. However, the importance of international trade to economic growth and job creation is a global issue reaching far beyond Danish borders. When small and medium-sized companies consider taking their product or service abroad, they depend on their bank for guidance on the best ways to facilitate the trade and counter the risks involved. The answer is often found in trade finance -- letters of credit, guarantees and straight export finance. Indeed, trade finance funds nearly US$ 18 trillion of commercial interactions between companies around the world annually.

There is by now a broad consensus that this vital part of the economy will be hit by Basel III - due to its approach to liquidity standards and off-balance-sheet financing which do not make allowance for trade finance's characteristics. Even with the concessions made in late 2011, there is a high likelihood that trade finance will become more expensive and less available in the years to come. Some companies will push through, find a solution and carry the extra costs incurred, but others will decide that it is not worth the trouble and stick to their home market.

The potential impact on global economic growth is very real. An annual cut in trade finance lending by 6 pct. combined with increases in the cost of extending credit of up to 40 pct. (which is what some banks estimate) could trigger a drop in international trade by more than 250 billion dollars. Even in cases when trade finance is available, the increases in costs will, in many cases, mean that contracts with foreign trading partners become unattractive.

—Confederation of Danish Industry

Natural Gas Faces Liquidity Drain

After analyzing the potential costs of posting cash collateral, Southwestern determined that during 2009, without hedging, Southwestern would have drilled 240 fewer wells in its Fayetteville Shale Project resulting in the loss of 1,500 jobs and a total economic impact to the state of Arkansas of $1.6 billion.

Texas–USA

Since 2005, Southwestern Energy Company has invested over $6.5 billion in its operations, all of which are located in the United States. These investments have resulted in substantial domestic job creation, from 248 in 2004 to approximately 1,500 employees today, an increase of over 600 percent.

Our ability to make over $6.5 billion of capital investments and create thousands of job opportunities during this period was primarily due to our ability to generate a reliable cash flow from the sale of our natural gas production and to gain access to additional funds borrowed under our bank revolving credit facility. The ability to generate a reliable stream of cash flow was due in large part to our use of OTC derivatives to "lock in" natural gas prices.

Southwestern regularly hedges its natural gas price exposure by entering into OTC swap transactions with multiple counterparties. Southwestern does not post collateral with any swap counterparty for a very good reason: natural gas swaps lower Southwestern's business risk and make it a much more stable company.

The imposition of mandatory clearing and mandatory margining of our hedges would cause a significant drain on working capital at a time when capital is highly constrained and credit is in short supply. There will be a liquidity drain on those companies that have taken a conservative business approach by choosing to prudently hedge their economic risks. Mandatory margining will have the unintended consequence of actually increasing financial risks as companies choose not to hedge due to working capital constraints.

If independent energy producers are forced to post cash collateral for natural gas hedging activities, they will be unable to fully invest in their business, the exploration and production of natural gas. The additional cost from posting cash collateral would be substantial and necessarily require that independent energy producers reduce their capital investments, resulting in a dramatic reduction in drilling activity, fewer jobs and a significant decrease in domestic natural gas production. There is a real world effect to a mandatory clearing requirement for all standardized OTC derivatives.

Based on testimony by Mark K. Boling, Executive Vice President and General Counsel, Southwestern Energy Company, Before the United States Senate Committee on Agriculture, Nutrition and Forestry, November 18, 2009.

There are concerns regarding the potential negative impacts on developing economies and Small and Medium Enterprises. The new Basel norms are likely to impact the credit rating of companies and banks will have to make higher provisions for lending to companies with lower ratings. As a result, higher interest costs can severely impact MSEs.

—Council Member, Confederation of Indian Industry (CII)

Regulatory proposals such as CRD IV & MiFID II remain a serious concern for non-financial end-users of OTC derivatives. These regulatory developments could effectively mean that money we should be spending in our primary business for product development, research and development and job creation, i.e. investments in growth and continued competitiveness, could instead be either spent on punitive credit charges or tied up in clearing houses as collateral.

—Based on Comments by Rolls Royce plc in response to Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP. Issued by ESMA / EBA / EIOPA 6th March 2012 (JC/DP/2012/1).

Financial Architecture Key

Basel Committee on Banking Supervision (BCBS)–Located in Basel, Switzerland, the BCBS provides a forum for regular cooperation among central banks and other financial authorities and makes recommendations regarding the prudential supervision of banking. It is made up of members of the G-20 plus other prominent financial centers such as Singapore and Hong Kong.

Basel III–Basel III is a set of global regulatory recommendations on bank capital adequacy, stress testing, and market liquidity risk, agreed upon by the members of the BCBS that strengthens bank capital requirements and introduces new regulatory requirements on bank liquidity and bank leverage.

Capital requirements–The amount of capital banks are required to hold in order to cover them against possible losses on the loans they grant and securities they invest in. Basel III has recommended a framework where a bank's assets (its loans and other investments) are weighted according to their risk. Those risk-weighted assets are then compared to the bank's capital in order to determine if it is adequately capitalized.

Capital Requirements Directive IV (CRD IV)–The CRD IV is the legislative vehicle in the EU for implementing the Basel III recommendations.

Clearinghouses–Clearinghouses, or central counterparties (CCP), act as the buyer to every seller in a market, and the seller to every buyer. Clearinghouses collect margins on every trade; members put money into a reserve fund as well. OTC trades that are not cleared will face a higher capital charge than contracts that are.

Counter-cyclicality–Having banks set aside more capital during good times, when they are suffering few losses on their loans.

Counterparty–From the point of view of one party to a transaction or contract, the entity on the other side is the counterparty. The risk assumed by either party that the other side (their counterparty) will fail to live up to its contractual obligations is "counterparty risk".

Credit Default Swap (CDS)–A CDS is essentially a type of insurance contract against default. It is a derivative contract in which the so-called buyer of protection (i.e., insurance) pays a stream of premiums to the "counterparty" on the other side of the trade (the seller of protection) in connection with a loan, bond or related index. If the issuer of the debt defaults, the insurance seller must pay the buyer the full face value.

Credit Valuation Adjustment Risk Capital Charge (CVA)–The CVA is a new fee recommended under Basel III which covers potential market value losses from deterioration in the creditworthiness of a derivative counterparty, short of actual default. The charge would be levied by banks in addition to the existing Default Risk Capital Charge.

Derivatives–Derivatives are financial instruments that "derive" their value from other assets. A 'forward' contract commits the user to buying or selling an asset at a specific price on a specific date in the future. A 'swap' is a contract by which two parties exchange the cash flow linked to a liability or an asset. They can be based on pretty much anything—commodities, currencies, shares, bonds, etc—as long as two parties are willing to trade risks and can agree on a price.

Dodd-Frank Act–The U.S. law passed in 2010 in response to the financial crisis. Its stated aim is "To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."

European Market Infrastructure Regulation (EMIR)–EMIR aims to reduce systemic risk in the financial system by requiring more OTC derivatives use clearinghouses.

European Systemic Risk Board (ESRB)–The ESRB is an independent EU body responsible for the macro-prudential oversight of the financial system within the Union, particularly regarding the prevention or mitigation of systemic risks.

Financial Stability Board (FSB)–The purpose of the FSB is to coordinate the work of national financial bodies and promote effective regulatory, supervisory and other financial sector policies. One of the 42 FSB members is the BCBS.

Financial Stability Oversight Council (FSOC)–The FSOC is a creation of the Dodd Frank Act. It is charged with the oversight of "systemically important financial institutions." Final rules for designation of systemically important financial institutions are expected to be put in place by the end of 2012 in a two-tiered approach. The first tier of companies will be designated as systemically important and subject to heightened supervision by the Federal Reserve, and the second tier of companies will be placed on a watch list for designation.

Group of Twenty (G-20)–The G-20 is the premier forum for international economic cooperation. It is a group made up of the 19 largest national economies plus the European Union. G-20 leaders, finance ministers and central bank governors, as well as the International Monetary Fund (IMF) and other key international institutions, meet regularly to address global economic and financial challenges.

International Association of Insurance Supervisors (IAIS)–Representing insurance regulators and supervisors in nearly 140 countries, IAIS promotes global regulatory cooperation in the insurance industry.

International Organization of Securities Commissions (IOSCO)–IOSCO is the Madrid-based association of agencies that regulate global securities markets. Overall, IOSCO aims to facilitate cross-border cooperation, reduce global systemic risk, protect investors and ensure fair and efficient securities markets.

Liquidity requirements–Along with capital requirements that ensure banks have reserves to cover them against losses on their loans and investments, they are also required to demonstrate that they have adequate liquidity, i.e., that they have enough cash in store in case of emergency.

Macro-prudential regulation–Macro-prudential regulation is regulatory policy aimed at maintaining the stability of the financial system as a whole.

Markets in Financial Instruments Directive II (MiFID II)–MiFID II is the proposed EU regulatory overhaul covering a range of investment services. It sets forth a comprehensive set of reforms which, if implemented, will lead to a reshaping of the EU financial markets, the products and services that banks provide and the relationship between banks and their customers.

Mark-to-market–Mark-to-market accounting sets the value of the assets or liabilities on your balance sheet to reflect the current market price of the asset or liability, or for similar assets and liabilities, or based on another objectively assessed "fair" value. This valuation becomes complicated when the assets/liabilities are rarely traded making it difficult to determine a 'fair market' price.

Over-the-counter (OTC) Derivatives–Contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary.

Securitization–Securitization is the process of turning individual, unique loans into tradable securities. For example, a bank makes loans to customers. It then sells those loans to other financial institutions. These financial institutions then take many such loans, bundle them together, and then divide the bundle into tradable pieces.

Shadow banking system–The shadow banking system refers to a system of lending and borrowing institutions parallel to the traditional banking system but outside of that system's tight regulatory constraints. It is oriented around non-banks which provide market participants and firms with an alternative source of funding and liquidity.

Systemic risk–Systemic risk refers to the possibility that a triggering event, such as the failure of an individual firm, will seriously threaten the system as a whole (and with it, the broader economy).

Too-big-to-fail–"Too-big-to-fail" generally refers to the idea that some institutions are systemically important enough that their failure would be too costly to risk. In other words, the direct cost of a bail-out and the accompanying moral hazard are assumed to be less than the cost of allowing a too-big-to-fail firm to go under.

Volcker Rule–Part of the Dodd-Frank Act, it bans proprietary trading and certain investments by banks to limit and regulate the amount of risk they can take on. Proprietary trading occurs when a financial firm uses its own funds to trade financial instruments, such as stocks and currencies for profit, and to establish an inventory that enables faster transactions for clients.

Endnotes

[i]"Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences", Report to the G20 Finance Ministers and Central Bank Governors, Prepared by the Financial Stability Board in Coordination with the International Monetary Fund and the World Bank, June 19, 2012.

[ii]Letter from FSB Chairman Mark Carney to G20 leaders, June 13, 2012.

[iii]Based on FSB Status Report dated June 19, 2012.

For more information about this report and the B20 Coalition please contact:

Gary Litman
Vice President, International Strategic Initiatives
International Division
U.S. Chamber of Commerce
www.uschamber.com/international

Principal Author and Content Partner:

Kristal Alley, Managing Partner
Alley Global Advantage
Email: kea@alleyglobaladvantage.com
Website: www.alleyglobaladvantage.com

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1615 H Street, NW
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