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November 1, 2011

Président Nicolas Sarkozy
Président de la République
Palais de l'Elysée, Paris, France.

EMBARGOED
Not for release before Noon local Washington DC time November 2, 2011 (i.e. 4.00 p.m. in the UK & 5.00 pm in Continental Europe).

Dear Président Sarkozy:

Since the G-20 Heads of State last met in Seoul a year ago, global policymakers have made progress on a number of fronts, with last week's Euro Area Summit providing more clarity to investors on the way forward for the Euro Area. From the vantage point of the Seoul G-20 Summit, global recovery looked much more assured—mature market countries were expected to see a pickup in growth in the year ahead, while growth in emerging market countries was expected to remain quite resilient. However, a year later the picture looks considerably bleaker. With business and consumer confidence at their lowest levels since 2009, the Euro Area is at growing risk of a return to recession—entailing significant spillover effects for other economies worldwide. Against this backdrop, your meeting this week should focus squarely on setting out ***strong, convincing measures to revitalize global growth***.

We welcome the overall thrust of the measures agreed last week by Euro Area leaders, which laid out a sound framework for addressing serious concerns about budget deficits and debt, the health of the banking sector, financial stability and governance. Financial institutions, represented by the IIF, have agreed to a significant one-time voluntary nominal debt reduction in support of Greece's reform program, which should lay the basis for restoring growth and investment in the Greek economy. Reinforced plans from Italy and Spain for deficit reduction and structural reforms are also most welcome. Nonetheless, we would underscore the challenges ahead in achieving both fiscal consolidation and renewed economic growth simultaneously—and the vital role of private sector financial institutions in helping to meet these challenges. With so much at stake for Europe, and for the global economy and financial markets, the G-20 should consider the most appropriate means of support for the Euro Area leaders in their quest for a comprehensive solution.

IIF reaffirms support for voluntary private-sector involvement (PSI), offering substantial debt reduction for Greece

The Greek PSI agreed on October 26-27 with the Heads of State or Government of the Euro Area opens a unique window of opportunity for Greece to pursue reforms with a greatly reduced debt burden and new momentum, building on the solid efforts of the past two years. This voluntary exchange, in tandem with an augmented and revised program of official sector funding predicated on continued fiscal and structural reform and completion of Greece's privatization program, can put Greece firmly on the path to debt sustainability. This would allow the necessary adjustment to proceed in a way that will permit the Greek people to realize the benefits of reform with less hardship. Importantly, this would also help bring in new investment capital and unlock market access—possibly as early as 2015. This would greatly reduce the burden on the official sector and the European taxpayer of providing perpetual support for Greece.

Following the recent announcement by Prime Minister Papandreou of a public referendum, the IIF reaffirmed its intention to move ahead with the October 26-27 agreement to reduce the nominal value of private-sector holdings of Greek government bonds by 50 percent. We will work closely with the Greek authorities, Euro Area officials and other relevant parties to agree and finalize details of the debt exchange; and move towards its swift implementation.

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More effective firewalls in Europe are urgently needed

Measures announced last week are welcome, and move clearly towards the enhancement of the European Financial Stability Facility (EFSF), as well as establishing a special-purpose vehicle for backstopping sovereign debt. These plans need to be fleshed out and reinforced, including through expedited efforts to attract capital from non-Euro Area official sources and private investors. As plans are developed in more concrete terms, ***it is essential that all parties come together behind the continued active role of the ECB in the secondary government bond market***. This will allow time for national authorities' adjustment efforts to take hold, and help stabilize markets at this crucial juncture. We would also emphasize that lower ECB policy rates at this point would enhance market stability as well as help bolster faltering regional economic growth.

Global regulatory reform is needed but bank recapitalization in Europe and broader measures will come at considerable cost

There is a clear need to restore confidence in Europe's banking sector, and the recapitalization plans for European banks are seen as a key part of the overall approach to this. But the scope and approach chosen will cause a number of serious problems. First, the market value of the debt of the countries most under scrutiny is likely to decline further as banks unload sovereign bonds. This is contrary to the goal of stabilizing and underpinning the outlook for sovereign debt in Europe. Second, the cost of raising capital in the current environment is prohibitive; European bank equity is trading close to 50% of book value, while the cost of issuing bank debt has risen sharply, by almost 2 percentage points over the past year. For some, new capital is not available in the market at all. Against that backdrop, ***it is inevitable that many European banks will shrink risk assets*** rather than try to raise expensive capital or be subject to forced capital injections. This will add to the financial sector deleveraging and contractionary pressures already evident in Europe. Data through September show that Euro Area bank credit growth remains weak, with lending to non-financial corporates increasing by only 1.4% in the first three quarters of 2011 compared to a year earlier. We estimate that if higher capital ratio requirements were to be met by mid-2012 relying only on retained earnings and a reduction in credit supply, overall credit exposure to the Euro Area private sector would need to *decline* by at least 5%. ***It is essential that the higher European capital requirements are a temporary measure as intended, not sustained over time and not seen as a new standard to be imposed more widely***. These measures along with the proposed transactions tax could also result in an increase in financial market fragmentation, intensifying the pressures facing Europe.

Looking beyond requirements designed to address specific problems in Europe, G-20 leaders are considering wide and deep reforms which will shape financial regulation for a generation to come. We have consistently supported effective and targeted reforms, including of capital and liquidity requirements. But policymakers' actions seem increasingly to be detached from the negative effect that they are having on the economic and financial market outlook. A recent IIF study, reinforced by the latest economic and financial developments, provides compelling grounds for being less sanguine about the economic implications of reform. The study concludes that ***neither bank capital nor long term funding can be raised in the quantities implied by the totality of current requirements without significant cost implications.*** This highlights the risk that financial sector deleveraging will continue, with serious implications for the cost and availability of credit, and hence for economic activity and jobs. With unemployment in the Euro Area now at over 16 million—an increase of over half a million in the past six months and nearly 5 million from pre-crisis levels—this is a very pressing concern.

We wish to underscore the following points to policymakers at this critical time:

- ***Banks should be a key support for economic recovery***. But the way in which regulatory reform is being implemented militates strongly against this. Banks are already putting in place many key reforms—such as increased core capital requirements, the capital conservation buffer; recovery and resolution plans and strengthened risk management and governance. But some reforms such as the proposed liquidity ratios (including their increasingly questionable emphasis on sovereign debt) are badly in need of reformulation while others—such as the surcharge on so-called "global systemically important banks" (G-SIBs)—will be costly and counterproductive.

- If banks are to play their part in supporting economic recovery, ***G-20 leaders need to look beyond narrow regulatory imperatives to the broader economic and financial context***. Implementation of an extensive and increasingly disparate array of regulatory reforms is not consistent with either economic recovery or financial stability. Policy makers should call a halt to the introduction of new regulation while the core elements of reform, such as increases in equity capital and recovery and resolution arrangements, are put in place. Leaders also need to reaffirm the principle articulated in 2009, that reform will only be truly effective if it is coordinated and interpreted and implemented consistently across major jurisdictions. ***Global regulations advanced by the G-20 need to be formulated and implemented on a truly consistent basis***.

- Above all, ***it is essential for the official sector to begin viewing the banking system as an indispensible partner in fostering recovery***, rather than an adversary on which it is necessary to impose ever more punitive measures with insufficient regard to coordination, cumulative effects, or interactions. Regulatory reform is needed and it will be accomplished. But unless it is accomplished in a way which permits banks to play their pivotal role in fostering recovery, the main benefits in terms of future stability combined with global prosperity will be lost.

Looking ahead: key issues for the G-20 in 2012

We continue to emphasize the urgent need for global policy coordination, encompassing a framework of consistent objectives, discipline and accountability agreed at the highest political level. This framework should facilitate finding coordinated solutions to key challenges including in particular the ***need to revitalize global economic growth and job creation against the backdrop of fiscal consolidation in many mature market economies***. In this context, the ongoing U.S. budget debate—which does not encompass vital spending and structural reforms—is a source of significant concern and should be a focus of G-20 scrutiny. Spillover from the still-troubled U.S. housing market remains substantial and should also be considered. Unless global coordination begins to focus on the problems of the largest economies, progress on global imbalances will be limited.

While solid emerging market growth should continue to support the global economy, this cannot be the sole engine. Many key emerging market economies are showing signs of decelerating growth, as they grapple in some cases with a range of issues including persistent inflationary pressures as well as rising concerns about asset quality in some countries. As Mexico begins its Presidency, ***the G-20 should seize the opportunity to encourage leading emerging market countries to take on a much more participatory role in global governance***. Growing economic and financial market interdependence underscores that we can no longer afford to be without the full engagement—and full commitment to global solutions—of all the world's systemically important economies.

On behalf of the global financial community, we continue to express our firm support for the G-20 in its challenging endeavors. We look forward to an approach that allows the private sector to play its essential role in supporting credit and economic growth worldwide.

Sincerely,

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