

# White Paper

## An analysis of the sell side response to the impact of new regulation

Adsatis

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### INTRODUCTION

So where do investment banks go from here? A flood of regulation from the US, a European regulator playing catch up and a clamp down on everything from compensation to proprietary trading. Combine this with a plethora of national rules such as those in the UK and Switzerland that may require 'add ons' to the capital ratios, and the potential for the ring fenced retail banks as advised in the UK and you have the potential for an uncertain outlook for investment banking. This dramatic landscape change is prompting the banks to revisit the banking model developed in the mid to late 1990's that made a virtue of using their balance sheets to give them the competitive edge in sales and trading to win capital markets business from clients.

During March 2011, Adsatis consultants interviewed 15 senior individuals from financial organisations to seek opinion on the likely impact of the legislation that has been passed in the US and the outlined European regulation. This updates the paper on this topic published in September 2010. Particular emphasis was placed on the sell side perspectives of the regulatory changes to gain a detailed insight into how actual and proposed regulatory changes will impact the business strategy of the different business lines in the markets divisions of the Tier 1 investment banks, with particular focus on Equity Derivatives and Credit Derivatives (although observations on other asset classes are also included). The objective is to understand the types of business that the leading banks are looking to pursue and the areas of key investment from a product, client and operating model perspective. The regulatory changes that are acting as the key drivers are Dodd-Frank (Volker Rule, Section 716, Position Limits, and OTC Reform (CCP)), European Market Infrastructure Regulation ("EMIR") Rules and Basel 2.5/Basel 3. The interviewees all worked for Investment banks and were based in the US, London and mainland Europe.

This report summarises the feedback that we received and observations on likely future developments in this area. Please note, the views expressed are those of the interviewees and, unless explicitly stated, not necessarily those of Adsatis Ltd.

### US REGULATION – THE DODD-FRANK ACT

#### Volker Rule

Designed to prevent risky trading activities in organisations with explicit or implicit government support by prohibiting "proprietary" trading, all respondents noted it was 'not if but when' their US based operations would be affected by this ruling. However, the legislation still lacks detail and, while it makes some specific exemptions ( allowing, for example, trading to support anticipated client/counterparty demands, hedging activities and all trading in certain instruments such as government and agency paper), a lot is still unclear.

A number of respondents have already, or are actively in the process of, closing down or repositioning their proprietary trading desks and internal hedge funds. Activity has included closing down funds and desks altogether or realigning them into separate divisions within the bank (i.e. moving activity to their asset management divisions). Many of those who were in the process of undertaking these actions noted that this was not solely a result of the Volker Rule and that, in most cases, they had started to wind down these activities as part of a wider rationalisation post the crisis.

A number of respondents were surprised at the speed at which some of their competitors had closed down their activities in these areas, given the rules could potentially allow activity up to 2019 (with the exemptions). Many felt that, given the 2019 date, any decisions on closure / 'spin off' would in the near term be driven by actual profitability and return on capital considerations rather than a need to comply with any regulation.

Nearly all respondents were concerned with the issue of territoriality. They felt that the regulator had yet to make clear whether the hedge fund and proprietary activities of US based institutions that were off-shored would be captured under the rules. Similarly, while the regulator had exempted certain activities, respondents were unsure how the regulators would monitor these activities and whether other activities designed to facilitate client/market activities would 'fall foul' of the rules. Many felt that the inability of the regulator to put what they believed would be a workable framework in place for the monitoring of proprietary trading would ultimately weaken the effectiveness of any regulation.

Interestingly, some respondents noted that, while the rule would have a limited effect on the profitability of the Tier 1 banks, those hardest hit would be the Tier 2 and 3 banks that have come to rely on their proprietary trading activities to provide a significant portion of their revenues.

### Swaps Push out

This provision (Section 716) is intended to require banks to spin out swaps desks which deal in those kinds of OTC derivatives deemed most risky. The key objective is to move the highest risk swaps trading into entities which are explicitly outside the 'Too Big to Fail' ("TBTF") parent entity, hence potentially protecting taxpayers' exposure.

Respondents were unanimous in their view that this was the least well thought out and most ill-conceived part of the Dodd Frank legislation. Many felt that it would ultimately be watered down or revoked.

While most respondents felt this would have little effect on their activities, there was the view that many had spent a considerable period of time consolidating their balance sheets over the previous few years to improve risk management. They were unsure if the rules would force them to separate businesses out into new subsidiaries to prevent them falling foul of the regulations. There appeared to be a consensus that, rather than strengthen the market, any extension of the use of subsidiaries would increase banks costs, operational risk, credit risk and reduce their ability to hedge these activities efficiently. A number of respondents noted that, if forced through, these cost increases would ultimately be borne by the client.

Many non-US banks felt there was also a lack of clarity around how the rules will affect their US operations. Many noted that to comply with the rule they may potentially have to set up new vehicles in which to do business, while at the same time being prevented from accessing the 'Fed Window'. This they felt made little or no sense.

### Position Limits

This provision could give the CFTC authority (pending appropriate studies) to limit positions in *any* asset but the clear focus is on commodity positions. All forms of position-taking could be included: OTC and exchange-traded. The objective is to limit speculative positions held by non-commercial participants in the wake, for example, of the run-up and subsequent rapid decline in oil prices during the 2008-09.

There was limited interest in this regulation among the respondents. A few noted that it could become an issue, if applied rigorously given current investor interest in commodity products. Again however, it was felt this was primarily aimed at poorly capitalised (agency?) organisations and expected that exemptions would be broad and, therefore, that the impact on investment banks would be limited.

## MOVE TO CENTRAL CLEARING

### Clearing in General

It is evident that central clearing will be mandatory for many instruments on both sides of the Atlantic. All respondents could see the reasoning behind the initiative and all felt that it was not an unreasonable ruling. However, many were still unclear of the extent and the type of products that would be required to clear and continued to stress the need for product liquidity for pricing and margining purposes. While most respondents expected the clearing of IRS would be expanded they also indicated that the type of credit default instruments would likely expand to include indices and (major) single name swaps. However, even at this late stage the eligibility for clearing of certain types of FX instruments has still not been resolved. Rumours that FX Options will definitely be included have not been confirmed and no clarification has been provided on forwards or currency swaps. However, current market opinion indicates that NDF's and options will not be exempted and look set to be regarded as eligible derivatives both in the States and EU.

As for Equity Derivatives, many believed that, given the market has worked relatively efficiently compared to other markets over the last 5 years, a move to have these products included would be unlikely to be in the first move to central clearing but that it could not be ruled out over the longer term.

A number of respondents repeated the fear also expressed last summer by our interview group that the idea of the TBTF bank was merely being replaced with the idea of the 'too big to fail CCP' and, if a CCP were to fail, that insufficient thought appeared to have been given with regard to who would tackle the problems associated with risk concentration, domicile and sovereign support? Concerns were also raised around the resource levels with sufficient expertise available within the CCPs to deal with the risk management and other challenges that would be faced as additional instruments were 'on-boarded for clearing'. A number of respondents felt some of the exchanges and CCPs', who were going to offering clearing facilities, still had a "futures based" clearing model mind set and this would need to change rapidly to accommodate the OTC instrument types.

Finally, a number of respondents were concerned about how the CCP's would ultimately differentiate their offerings. While many noted that the first move could be a 'dive to the bottom' with regard to clearing fees, capital requirements and default fund contributions, others felt that the only ultimate differentiator would be how the CCPs' calculated collateral requirements and who offered the most favourable terms and conditions on this aspect.

### Client Clearing

The vast majority of respondents, particularly most of the larger banks, have accepted that they need to be in this 'space' but views varied considerably on the appropriate strategy. Some banks are openly embracing the idea and see clearing as a potential revenue stream while others believe they have to offer service merely to retain market share. Perhaps unsurprisingly, given the above views, the appetite for taking on the costs of providing these services differed markedly between those wishing to offer a full range service and those only intending to provide a minimal service.

Most respondents believe that the clearing space would ultimately be dominated by 10-12 large banks and those with large prime brokers and clearing services operations were already well positioned to take the lead. A couple of respondents noted that the growth in the clearing market could potentially open up opportunities for the large custodian banks such as BNY Mellon, State Street and RBC Dexia whose impartiality with regard to execution would enable them to partner with dealers to offer their expertise in client clearing without posing a competitive threat in terms of the market share of transactions.

The views of respondents concerning their ability to charge for clearing service were mixed. Many believed that certain clients would expect the service to be free and a number were already adopting the approach of 'if we execute the trade we will clear for free'. However, some banks were seen to be adopting a 'pay to play' approach whereby certain value added services would be charged to the client. These could include such things as, portfolio clearing, collateral transformation and FX services. However, given that the mandatory clearing environment was so new it was generally recognised that most banks would need to evolve their commercial model before finding the right solution.

## BASEL RULES AND THE OVERALL IMPACT ON BANK BUSINESS MODELS

### Basel 2.5 and 3

Whilst recognising its importance this was seen by many of the respondents to be at the back of the queue in terms of priorities. Many respondents are concerned that the plethora of regulation with more immediate deadlines, e.g. Dodd-Frank and EMIR, means that Basel 2.5 and 3 are not necessarily being focussed on as they should. They felt that within jurisdictions regulators are working in silos and are not looking at this holistically to ascertain the impact Basel may have on liquidity ratios alongside what the other regulation does to impact long term business models.

The majority of respondents noted that one thing was clear, even with mitigation the Risk Weighted Assets that banks will need to hold for their credit based businesses will increase dramatically. Some were projecting a doubling of the capital allocated to these businesses. Given that capital usage was likely to increase but relative contribution to earnings was likely to stay static, many noted the focus would undoubtedly fall on divesting certain capital intensive businesses such as securitisation.

A number of respondents noted the need to take a much more holistic view of capital requirements given that some local regulators were pushing for significantly higher capital ratio levels than those laid out in the Basel Accord. Both the UK and Switzerland have already indicated they expect their banks to face higher capital requirements with the UK indicating that the UK Banks will require at least a 10% minimum Tier 1 capital ratio and Switzerland suggesting a punitive 19%. On the other hand, recent rumours in the US around an 8% capital requirement for Systemically Important Financial Institutions ("SIFI's") and the approval from the Fed that the stronger banks can start paying dividends is a clear indication that the FED believes bank capital ratios are close to where they want them to be. Many felt that the great unknown in the space was what the regulators in the Far East would do with regard to capital requirements. Regulatory 'capital' arbitrage was seen by many as not something that *might*, but something that *will* happen and it was only a matter of time. Also, anecdotal evidence such as Mike Bloomberg suggesting that the regulatory environment in the New York would suit Barclays better than that in the UK only adds fuel to that fire.

### New Business Models for Investment Banks

Many respondents felt that their banks were currently in a very difficult position and were unclear whether they should invest now and drive the market change and move to a new business model to get first mover advantage or wait and reap profits for the next 2 or 3 years but risk being late adopters if expected 'rules' are adopted as expected.

A number of respondents also noted that the banks were again reviewing their holdings of low or unrated RMBS/ ABS with plans to sell them off in an effort to reduce potentially punitive Basel capital requirements.

However, some thought that securitisation will begin to move forward again as a business but with an emphasis on higher quality asset and receivables. While Basel will make securitisation much less profitable due to capital requirements it is still a business

where there is money to be made. Many respondents noted that capital 'light' businesses such as FX and, to a certain extent, vanilla credit derivatives would continue to be funded.

One specific reorganisation that some respondents felt could occur was in the role and positioning of the front office credit risk management function (sometimes called "CVA desks"). Over the past 5-8 years, these desks have developed to avoid individual derivative trading desks hedging/managing their own counterparty risks and paying the spread in the CDS market when the bank's overall exposure may not require it. The move of high volume OTC derivatives to central clearing obviously modifies this function: if the trade is to be moved to clearing then there will be no trade specific CVA charge; if it is an ineligible trade, then a CVA calculation will still be required. However, in addition to this qualification, banks are realising that there may be a number of other post-trade costs (particularly funding costs) that may be incurred which should be calculated at point of sale, as has been the case with CVA. These other charges will depend on the nature of the contract between the bank and the counterparty, normally written into a Credit Support Annex (or "CSA"). The desk may be required to widen its role to cover real time calculation of all these charges (particularly the funding implications of the trade), given the differential regulatory capital requirements of derivatives depending on whether they are cleared or not cleared.

Given that commercial models are not yet developed for all these additional post trade services provided by (or costs incurred by) the banks to/for their customers, the role of such a function may prove critical to profitability of derivative businesses. The additional requirement for execution prices to be published on a Swap Execution Facility ("SEF"), or equivalent, means that banks will still be competing aggressively on basic pricing and, therefore, need to know the estimate of the specific costs likely to be incurred before posting a price or responding to an RFQ. Thus we are seeing the potential for functions which historically have been largely post trade (risk, regulatory capital, clearing, settlement, etc) and built into the overall infrastructure, move into a more prominent role, or at least the pricing of these services moving into a pre-trade function.

While most agreed the greater degree of transparency engendered by electronic notification of pricing, clearing and trade reporting (although details of all these have yet to be defined) was likely to cause bid to offer spreads to narrow, there was disagreement around how much this would drive volume increases. While most respondents felt volumes would grow, many questioned the ability of banks to hold on to client business as the SEF based trading environments becomes more prevalent and clients have increased access to "best price".

The SEF proposals themselves also potentially present a challenge for the banks. Some respondents cited the practical difficulty of connecting to multiple SEF's, particularly given the likely proliferation in the early stages and the uncertainty of which platforms will be the long term winners.

## CONCLUSION

How much this changes the overall business model for investment banks is yet to be seen. However, it does suggest that the changes initiated by the growth in the derivatives business during the period up to 2007 and the upheavals caused by the subsequent financial crisis, will be far reaching and that these will be reinforced by some of the key components of the new regulation. The key change is the increased emphasis on holistic risk management and the need for more accurate pricing of capital and the need to put this at the centre of a bank's revenue generating activities.

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