



Evaluating the Relationship between Post-Crisis Regulatory Reforms and Changing Capital Markets

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About The Clearing House

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Payments and Advocacy. 160 years later, The Clearing House remains the gathering place for industry leaders to chart the course of U.S. banking and continues its rich tradition of developing and operating industrial-strength payments systems.

- **The Clearing House Payments Company** clears and settles almost \$2 trillion daily (nearly half the ACH, funds transfer, and check image payments in the U.S.) and works to ensure that the new generation of payments evolve in a consistent, safe and sound manner.
- **The Clearing House Association** is a nonpartisan advocacy organization representing the interests of its Owner Banks on a variety of systemically important banking issues.

Bank Leadership. The Clearing House is owned by the nation's largest commercial banks. The CEOs, general counsels, payments executives and countless subject matter experts are actively engaged with The Clearing House to address issues of importance to commercial banks and their customers.

Presentation Outline

Two Crude Models for Thinking About the Transformation of Capital Markets

A Few Empirical Examples of the Transformation in Progress

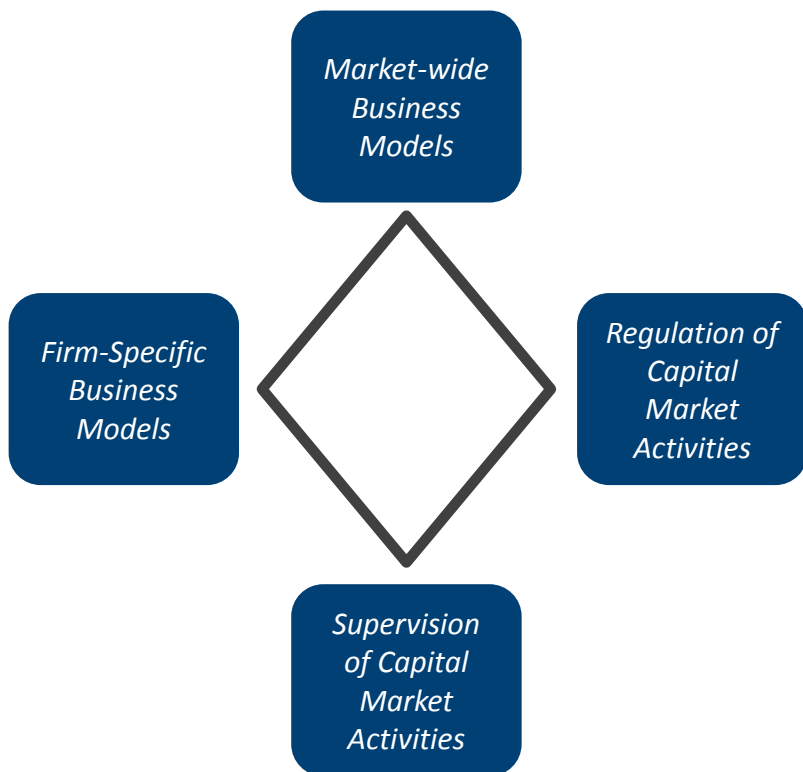
Regulatory Reform as Transformational Agent

Capital Markets Implications of Key Regulatory Reforms

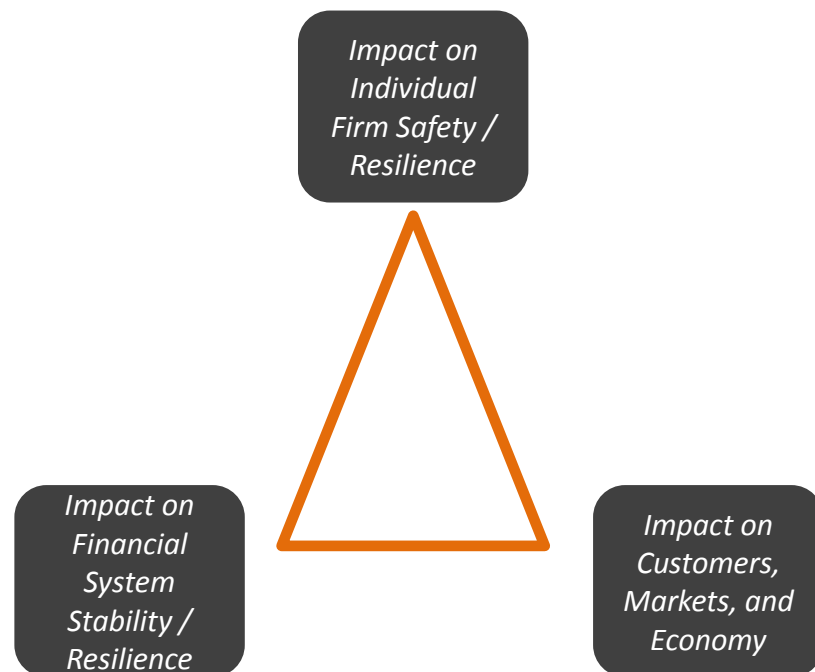
Observations and Challenges

Two Crude Models for Thinking About the Transformation of Capital Markets

Drivers of Change:



Assessing the Impact of Change:

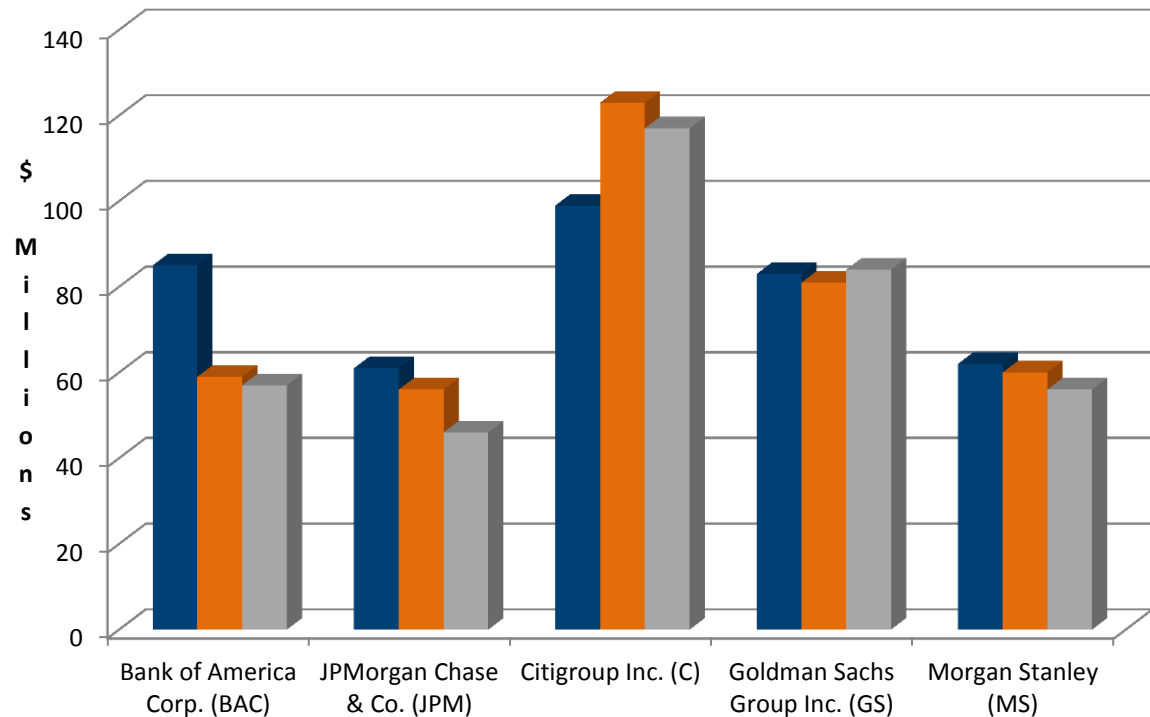


A Few Empirical Examples of the Transformation in Progress

De-risking

- From a risk perspective, banks continue to de-risk their balance sheet and their business compared to prior levels, as is evident in recent public data (95%/99% one-day trading VaR as of the end of business day for each quarter).

One-Day Trading VaR for Large U.S. Banks
(\$ Millions)



Source: SEC 10-Q Filings

■ 2013Q1

■ 2013Q2

■ 2013Q3

A Few Empirical Examples of the Transformation in Progress

Changing Trading Volumes

- Industry volumes continue to show a declining trend over a 3-year period from 2010-Q3 2013, as FICC products such as agency securities, other mortgage-backed securities, convertibles, corporate bonds all show declining volumes compared to 2010 levels; declines range from 38% for agencies to 10% for corporate bonds.
- In contrast, over the same periods:
 - Banks have generally *increased* holdings of treasuries; and
 - Loan growth—especially C&I lending, mortgage originations, real-estate lending (such as commercial real estate), has been relatively stronger compared to trading and capital markets activity.

Repo Book Maturities

- It appears that many banks, likely in response to the climate of political uncertainty on the debt ceiling negotiations and the potential for default, increased the maturities of their repo books and shed short-term T-bills during Q3 2013.
- For instance, the yield on the T-bill due Oct. 31, the benchmark one-month T-bill, rose to a peak rate of 0.167% on October 3. The one-month T-bill's yield traded at 0.135% on September 26, much higher than 0.023% on the benchmark three-month T-bill due Jan. 1, 2014 as investors sold the shorter term securities. At the same time, cost of borrowing in repo markets rose, as the benchmark overnight repo rate for Treasury debt traded at a peak of 0.07% on October 3, up from 0.05% on October 2, and 0.03% on September 27. The rate has traded in a range between zero and 0.1% since the start of June.

A Few Empirical Examples of the Transformation in Progress

Derivatives Central Clearing

- As of June 2013, the FSB estimates that only 42% (or \$163 trillion) of the total interest rate derivatives notional volumes (or \$305 trillion) among G-15 dealers were being cleared by CCPs, *although this number has doubled since January 2013.*
- A similar picture is emerging for (cleared) credit derivatives, according to research firm Aite Group, the aggregated open interest volumes of cleared OTC derivatives (e.g., interest rate swaps (IRSs) and credit default swaps (CDSs)) sat at US\$10.7 trillion in January 2013 and rose to US\$20.6 trillion by June 3, 2013 for ICE, LCH Swaps Clear and CME.

Derivatives Margin

- A recent ISDA paper found that mandatory clearing called for by the Dodd-Frank Act would increase variation margin by \$30 - \$50 billion among U.S. banks; clearing requires payment of initial margin as well. The ISDA report also shows that the imposition of mandatory initial margin payments for both cleared and non-cleared transactions, in addition to charges imposed by Basel III for non-collateralization, is forecast to increase the value of collateral held against all OTC derivatives by \$2 trillion, an increase of 50% from current levels.

Regulatory Reform as Transformational Agent



Capital Markets Implications: Balance Sheet Regulation

Example: Basel III Capital Rules

- Background: The Basel III capital framework requires banks to hold higher amounts and quality of capital, and impose more stringent risk weights on a variety of asset classes. In July 2013, the U.S. agencies issued final rules implementing the Basel III framework in the United States, which are effective generally for advanced approaches banks on January 1, 2014, and for others on January 1, 2015.
- Capital Markets Implications: More stringent capital requirements for market risk through introduction of the Incremental Risk Charge, use of Stressed VaR, and incorporation of greater risks in internal models; capital requirement for Credit Value Adjustments against MtM losses from counterparty creditworthiness changes; and elimination of AOCI filter. Fundamental Review of the Trading Book may have further implications.

Example: Liquidity Coverage Ratio

- Background: In January 2013, the Basel Committee issued a revised liquidity coverage ratio (“LCR”), which requires banks to hold sufficient liquidity to survive a 30-day period of liquidity stress. In October, the U.S. banking agencies issued a proposal to implement the LCR that is more stringent than the Basel Committee standard: the denominator of the LCR is calculated on the worst day of the 30-day liquidity stress period (v. 30-day cumulative calculation); shorter transition period; application on stand-alone basis to \$10B+ IDIs of advanced approaches BHCs.
- Capital Markets Implications: Changes to relative preference to hold certain assets classes depending on treatment; outflow assumptions target and significantly impact derivatives and prime brokerage.

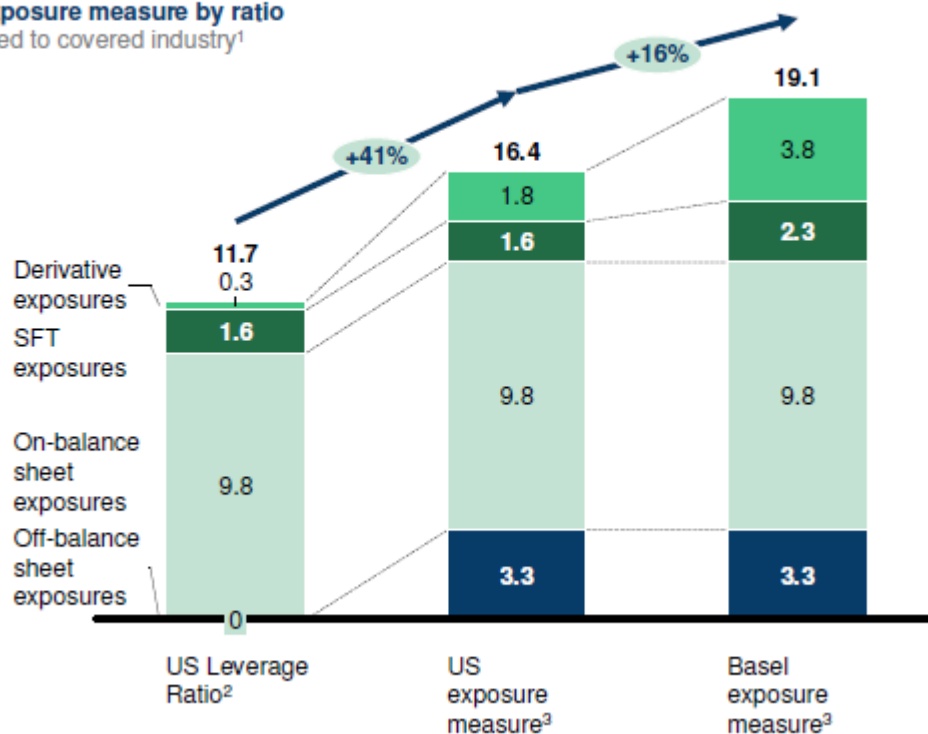
Capital Markets Implications: Balance Sheet Regulation

Example: Leverage Ratio

- Background:** U.S. and international policymakers are currently reconsidering whether to make the Basel III supplemental leverage ratio more stringent. The Basel Committee has proposed to expand the supplementary leverage ratio's denominator as it applies to derivatives, repos, and securities lending transactions. In the U.S., agencies have proposed to increase the leverage ratio requirement for U.S. G-SIBs to 5% at the BHC level and 6% for IDIs.
- Capital Markets Implications:** Disincentive to low-risk exposures (e.g., cash, U.S. Treasuries, plain vanilla rate swaps, etc.); proposed Basel Committee denominator changes significantly impact derivatives, repos, securities lending/borrowing, and related collateral arrangements.

Overall exposure measure increases by 16% from US proposed to Basel proposed exposure measure

BHC exposure measure by ratio
\$T, scaled to covered industry¹



Source: The Clearing House, *Assessing the Supplementary Leverage Ratio* (Sept. 20, 2013), p. 4

Capital Markets Implications: Balance Sheet Regulation

Example: Net Stable Funding Ratio

- Background: The net stable funding ratio (“NSFR”), another Basel III liquidity metric, requires banks to hold a minimum amount of funding that is expected to be stable over a one-year time horizon based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures. Like the original LCR, the NSFR calibrations proposed in 2010 are viewed as overly conservative, and the Basel Committee has announced that it will review and revise the NSFR before it is finalized towards the end of 2013 or early 2014.
- Capital Markets Implications: Final formulations of “required stable funding” and “available stable funding” will have a significant impact on nearly all types of capital markets activities, trading portfolios, and funding models.

Example: Short-term Wholesale Funding Reform

- Background: The Fed has signaled its interest in a variety of further reforms to address systemic risks in short-term/wholesale funding markets, including a capital surcharge for firms especially reliant on wholesale funding, special NSFR or other measures targeted at matched book repos, and minimum margin/haircuts on securities financing transactions (“SFTs”).
- Capital Markets Implications: Varies depending on the types of additional measures pursued, but very likely to specifically target and significantly impact repos, securities lending/borrowing transactions, and/or other short-term, “bank-like” liabilities.

Capital Markets Implications: Risk Management Regulation

Example: Heightened Risk Management Standards under § 165 of the Dodd-Frank Act

- Background: As required under § 165 of the Dodd-Frank Act, the Federal Reserve has proposed (but not yet finalized) new risk management requirements for certain banking organizations with more than \$50 billion in assets, including requirements that such organizations (i) charter a Risk Committee of the Board, which must have at least one member with risk management experience and an independent director, and meet frequently and keep records, and (ii) have a chief risk officer, appointed by the Board, who reports to both the CEO and the newly created risk committee.
- Capital Markets Implications: Significantly impacts the organization and reporting architecture of bank risk functions overseeing capital markets and trading activities.

Capital Markets Implications: Market Structure Regulation

Example: Title VII of the Dodd-Frank Act

- **Background:** Title VII of DFA and related reforms overhaul nearly all aspects of the derivatives marketplace, with regulation of derivatives divided between the CFTC (which is responsible for swaps) and the SEC (which is responsible for security-based swaps). Many of these reflect consensus G-20 mandates.
- **Mandatory clearing:** Derivatives must be cleared if they meet certain criteria (e.g., factors relating to outstanding notional exposures, trading liquidity, adequacy of pricing data, and the availability of an appropriate clearing organization). Certain traders with commercial end-users are exempted.
- **Exchange trading:** Derivatives subject to clearing requirements must be traded on an exchange or a registered swap execution facility (unless no exchange or swap execution facility makes the swap available to trade). Swaps (or security-based swap) with retail persons must be traded on an exchange or SEF.
- **Data reporting:** Derivatives must be reported to a registered swap data repository, whether or not they are cleared, for both real-time public dissemination and for the confidential use of regulators and supervisors.
- **Business conduct:** DFA and similar overseas reforms have established business conduct standards (e.g., requirements that counterparties be provided with specified information regarding the proposed transaction, its risks, and how the transaction will be cleared, and that dealers be “fair and balanced” in communications with counterparties.
- **Dealer/major participant regulation:** Dealers and major market participants must register with the CFTC, SEC, or other applicable regulators and comply with prudential and other rules regulating the swap/security-based swap activities of such firms, including capital and margin rules.
- **Capital and margin:** The Basel Committee and IOSCO have agreed to global standards for initial and variation margin on non-centrally cleared derivatives, which are expected to be implemented in the U.S. in early 2014.

Capital Markets Implications: Firm Structure Regulation

Example: Volcker Rule

- Background: The Volcker Rule prohibits banks from engaging in “proprietary trading” and from owning or investing in hedge funds or private equity funds. The U.S. banking agencies are expected to finalize implementing rules on December 10, 2013.
- Capital Markets Implications: Significantly impacts nearly all aspects of banking organizations’ market-making, underwriting, and hedging activities and the relevant markets served, especially in less liquid asset classes.

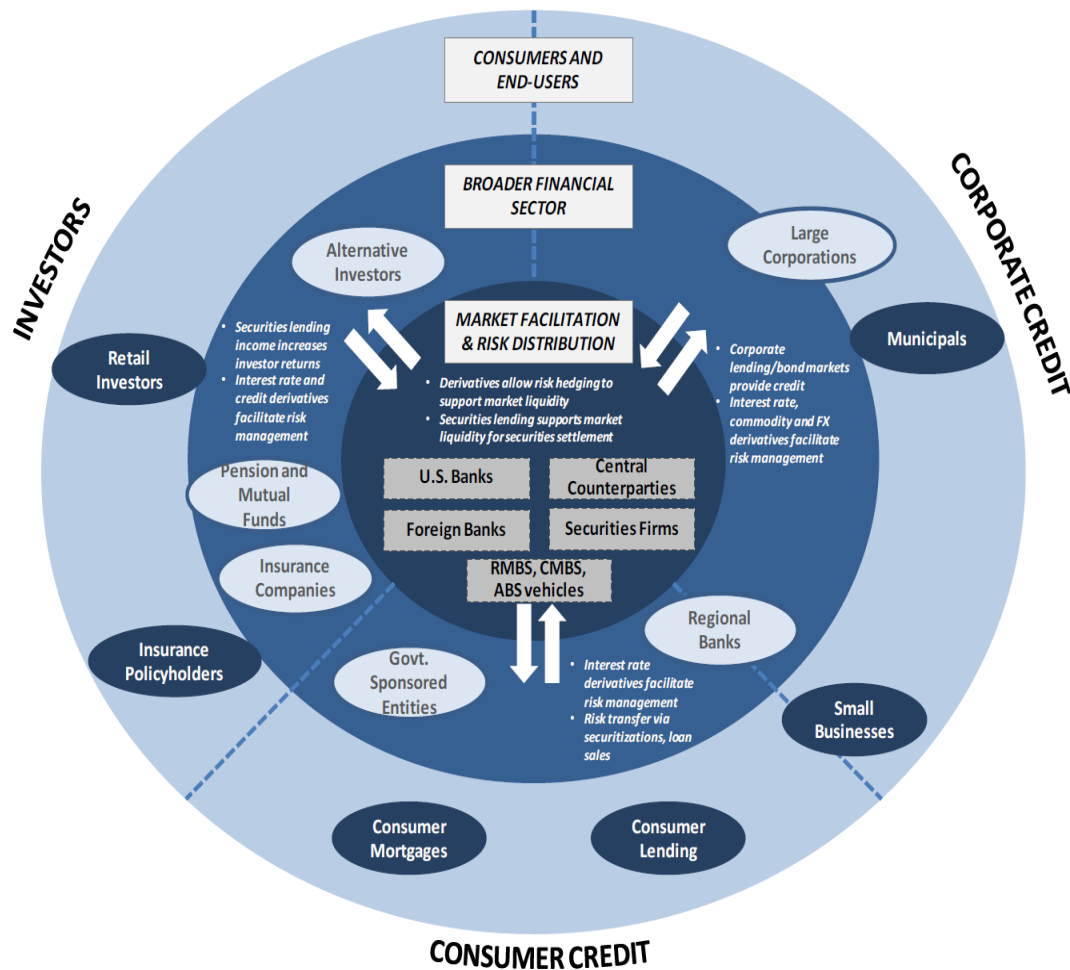
Example: Swaps Push-out

- Background: Section 716 of the Dodd-Frank Act, commonly referred to as the derivatives push-out requirement, generally prohibits insured depository institutions that are swap dealers from engaging in certain derivatives activities. Covered institutions will effectively be required to “push out” dealing in commodities derivatives, equity derivatives, and uncleared credit default swaps to a separately-capitalized affiliate.
- Capital Markets Implications: Significant restructures a variety of derivatives dealing activities to occur outside the IDI legal entity, entailing changes to bank booking models and management practices, counterparty relationships and margin arrangements, and overall market structure.

Capital Markets Implications: Firm Structure Regulation

Example: Counterparty Exposure Limits

- Background:** The Fed has proposed limits under § 165(e) of the Dodd-Frank Act that would limit certain bank's exposure to any single counterparty to no more than 25% of its capital ("single counterparty credit limit" or "SCCL"). If each counterparty has at least \$500B in assets, a lower limit of 10% was proposed. In March 2013, the Basel Committee proposed a revised international standard for large counterparty credit exposure limits that is similar.
- Capital Markets Implications:** Depending on final shape of the rule, measurement approaches to derivatives and SFT exposures could force many large banking organizations to substantially reduce their credit intermediation and market-making activities in order to reduce their exposures within limits.



Observations and Challenges

There are multiple simultaneous drivers of change in bank capital markets activities and the capital markets themselves, which are likely to be difficult to differentiate and understand in practice.

A number of the most significant regulatory drivers of change in capital markets are not yet fully (or at all) in force, meaning significant impact and change is still to come.

The cumulative impact of the many regulatory (and other) drivers of change in capital markets have been little studied and are not well understood – especially where impact to customers and the functioning of specific financial markets is concerned.

The adaptive response of shadow banking markets to current and likely future changes in capital markets is likely to have a major impact on financial stability and customers/markets, but is not well understood.

Uncertainty about the exact shape of the regulatory “new normal” is in and of itself, likely to be a major driver of change in capital markets all by itself.

A fourth potentially key driver of the future shape of bank capital markets activities (and the capital markets themselves)—the supervision of these activities and markets by regulators within the regulatory landscape—remains almost entirely “TBD.”