Regulatory Reform and the Changing Landscape of Banking

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Introduction

Since the onset of the financial crisis banking regulation, once a boring topic only to be discussed among specialists, has become front-page news almost on a daily basis. Given the natural backlash to the role of big banking and weak regulation in creating the crisis, there has been a strong and general political will to re-regulate finance generally and banks in particular. This was a predictable outcome of the crisis. What might be more surprising is that under the aegis of the G-20 financial reform on both sides of the Atlantic has a strong common thrust.

- Finance based on complex financial structures involving OTC derivatives had contributed to the poor assessment and poor management of risks. There needs to be greater transparency in derivatives markets
- More and better capital
- Deal with the too big to fail problem by either improving resolution regimes so that no institution is too big or important to fail. Alternatively, recognize that some institutions are indeed too important to allowed to fail and therefore hold these institutions to a higher prudential standard of oversight and, in all likelihood, capitalization.
- Introduce a framework for systemic risk regulation where responsibilities are clearly spelled out and powers to intervene are firmly established.

The broad outlines of the new regulatory framework are now in place, and we have reached the stage when details of implementation are being filled in.

The financial sector has already undergone major restructuring since 2008 with the disappearance of once-mighty players, massive increased involvement of state etc. However, I would argue that given the major changes in regulation the financial sector will continue to change in major ways over the years to come. In this talk I discuss what I think are the major forces driving change and, more speculatively, suggest some of the possible forms that new finance will take.

Recap of the main changes to banking regulation since the 2008.

US: the Dodd-Frank Act creates the most substantial changes in regulation of financial markets since the 1930s

EU: CRD III and CRD IV, Solvency II and other regulatory enhancements cover most other areas analogously to Dodd-Frank

US: The Financial Stability Oversight Council
EU: The European Systemic Risk Board

US: Federal Reserve supervision of all systemically-important financial institutions in the US
EU: Pan-European Union supervisory authorities established for banking (EBA), securities markets (ESMA), and insurance and pensions (EIOPA)

Stricter guidelines on compensation policies in the financial industry
In some countries levies on banks
In some countries strengthened recovery and resolution regimes in the US, UK and Germany

However the most important changes that cut across the whole system are probably changes wrought in Basel 2.5 and 3.

To strengthen bank solvency the Basel Committee has:

Modified regulatory capital standard in major ways:

$$\frac{Capital}{Risk - weighted - assets} \geq Minimum$$

Tightened the definition of the numerator by restricting it mainly to tangible common equity.

Increased the denominator by raising the risks weights on many of the assets that a bank holds particularly those in its trading book (Basel 2.5)

Raised the required minimum capital ratio The regulatory minimum required level of common equity is increased from 2% to 4.5% of the bank's risk-weighted assets. A higher ratio of total Tier 1 capital is required: from 4% to 6% of risk-weighted assets.

Introduced two new minimum Liquid Asset Requirements for Banks:

The Liquidity Coverage Ratio – to ensure that banks have enough liquidity to weather short periods of intense market stress

The Net Stable Funding Ratio – to ensure that banks do not engage in excessive maturity transformation or rely too heavily on unstable short-term wholesale funding

Proposed to add an additional 'Capital Conservation Buffer' -- that is to be built up during the upswing of the credit cycle as a 'war chest' that can be drawn upon during a financial and economic downturn – to reduce the 'procyclicality of the Basel capital framework.

Proposed a non-risk-weighted Leverage Ratio

Quantifying the effects of Basel 2.5 and 3

McKinsey recently attempted to quantify the effect of these changes based on information on 13 of the largest investment banks or universal banks. Using information provided by the banks on their wholesale banking activities in 11 lines of business and making assumptions about required minimum capital (10% tier 1).

Before taking into account any mitigating actions by banks, the overall estimated impact of regulatory changes are very large a drop of ROE from 20% in the baseline for the wholesale banking activities taken together to 7%. For the 13 banks considered this drop is partially from a drop of profits from $40 billion to $30 billion. But more of the drop is due to the dramatic increase in required capital from $200 billion to $400 billion. Much of the increase in required capital is coming from changes brought by Basel 2.5 rather than an increase in the minimum required capital brought by Basel 3.

The impact effect varies greatly by source of the regulatory change and by line of business as set out in the following table:

Exhibit 3

All businesses are affected, especially structured credit and rates.

ESTIMATE

Return on equity before and after regulation

1 Market-risk framework
2 Counterparty-credit risk
3a OTC shift: RWA[1] reduction
3b OTC shift: revenue impact
4 Capital ratio
5 Leverage ratio
6 Liquidity and funding costs
Most significant impact

Businesses	Preregulation %	Basel II.5 (Percentage points) 1	Basel III and other regulations 2	3a	3b	4	5	6	Post-regulation %	Delta %
Foreign exchange	30	–8	0	0	0	–4	0	–2	16	–45
Flow rates	19	–6	–5	4	–1	–2	0	–1	8	–60
Structured rates	15	–4	–6	1	–1	–1	0	–1	4	–80
Flow credit	18	–8	0	0	–1	–1	0	–1	6	–65
Structured credit	17	–9	–2	1	–1	–1	0	–1	3	–85
Commodities	20	–6	–3	1	–1	–2	0	–2	8	–60
Cash equities	25	–5	0	0	0	–3	0	–2	15	–40
Flow EQD[2]	25	–8	–1	2	–5	–2	0	–2	9	–65
Structured EQD[2]	27	–10	–4	1	–1	–2	0	–2	9	–70
Prime services	15	0	0	0	0	–3	–3	–1	8	–45
Proprietary trading	35	–22	–1	0	–1	–2	0	–2	7	–80
Total capital markets	**20**	–7	–3	2	–1	–2	0	–1	7	–65

1 Risk-weighted asset.
2 Equity derivatives.

Structured products (rates, credit, and equity) and proprietary trading are particularly hard hit.

To be sure these estimates are sensitive to a number of important assumptions about which one can debate. But these are relatively detailed matters and in my discussions with bankers in the City, I think most would not view them as very unrealistic. The main conclusion is that heightened capital charges and the new liquidity ratios will make the wholesale business as practiced in the last 10 years much less profitable. This assumes, however, that the banks do not change their practices to respond to this changed regulatory environment, which of course, they will do. What are the main actions that the major international banks will take, and indeed, in many cases are already underway?

Mitigating the effects

Mitigating actions will come in four major areas:

- improved risk management models,
- improved financial efficiency to conserve capital and liquidity,
- enhanced operational efficiency, and
- portfolio optimization.

Taken together, McKinsey estimated that actions in these directions will restore 4% or 5% of ROE, i.e. from 7% to 11-12%. The biggest gains from mitigating actions come from portfolio optimization. But what does portfolio optimization imply?

To some extent this involves improved hedging to exploit capital preservation hedge opportunities under the Basel framework. Also, this involves changing the composition of the portfolio away from capital intensive activities like some securitization structures. But the largest gains come from restructuring and unwinding positions and from asset sales. The businesses where returns fall far short of a normal cost of capital (say 10.5%) are structured rates and structured credit. Here we can expected the pull-back by large banks to be sharpest.

In fact, this last point can hardly be called a prediction. It is more a statement of fact. Everyday in the financial press provides reports of large banks hiving off one business or another as they seek to free up capital.

If large banks are retreating, what will fill the gap?

Capital markets: REITs should grow. Development of ETFs ETNs…But there will be a continuing appetite for debt. There will be a continuing need to achieve the maturity and risk transformation that is the traditional role of the banking sector.

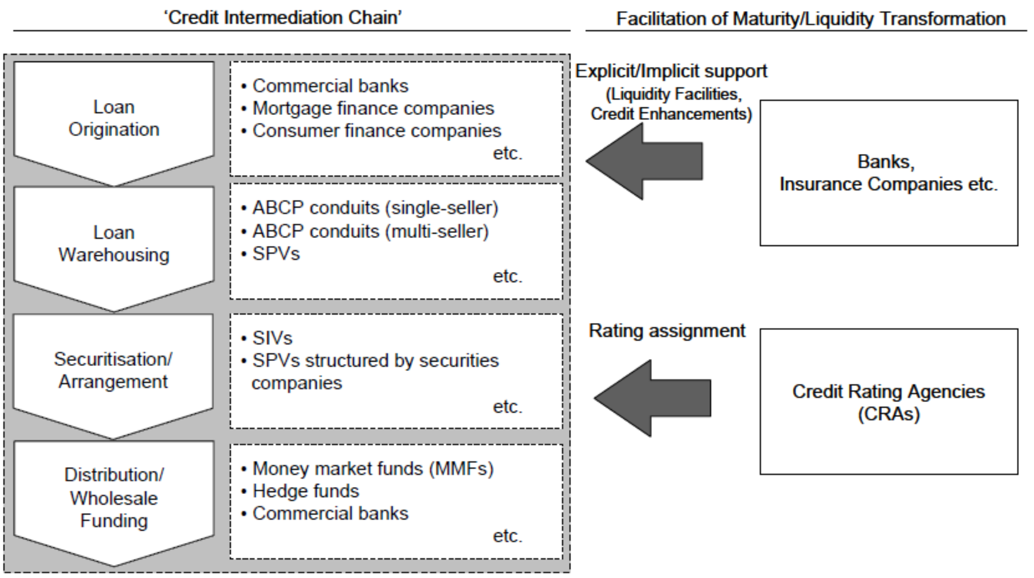
New banks and specialized investment companies. The planned SIFI capital charge will create a comparative advantage for medium and smaller institutions. Not all jurisdictions will impose higher capital charges in step. European Union is on course to push for higher chargers faster than the US. (US did not fully adopt Basel 2.) However, there are strong incentives to develop financing while avoiding banks where this is possible. Hedge funds, insurance companies, private equity all may gain.

Emerging financial centres: Globalized finance may increasingly by-pass US and Europe. HK, Singapore, Dubai and other financial centre in Asia are set to make gains.

The old and the new shadow banking sector: In effect we are predicting that global finance will develop increasingly through the shadow banking sector. This is not new. The New York Fed estimates that before the onset of the crisis the volume of credit intermediated by the shadow banking system was close to $20 trillion, or nearly twice as large as the volume of credit intermediated by the traditional banking system at roughly $11 trillion. In 2010 the comparable figures were $16 and $13 trillion, respectively. My guess is that shadow banking will grow to be more than twice the size of the traditional banking system.

The FSB defines shadow banking as "credit intermediation involving entities and activities outside the regular banking system". Shadow banks include finance companies, asset-backed commercial paper (ABCP) conduits, limited-purpose finance companies, structured investment vehicles, credit hedge funds, money market mutual funds, securities lenders, and government-sponsored enterprises. In the future the shadow banking sector will be shaped by changes in regulation and financial market developments. What we have learned is that financial innovation has the ability to seek out the smart ways of reducing the costs of regulatory capital. (Liquidity swaps are a recent example of this.)

Exhibit 1: The Shadow Banking System



Source: Financial Stability Board

Wither securitisation? One can often hear it stated that the securitisation market is dead and will not come back. This may be true for major banks where the capital costs of securitisations have risen sharply. It is also true that currently there are large portfolios held in liquid asset currently that can be deployed as volatility drops and investors develop longer term strategies. Eventually, however, once economic recovery is firmly underway, investment funds will be tight. There will be a desire to "reach for yield" and a need to reconcile long-term investment needs with the desire to keep assets in relatively liquid form. That is, there will be the same needs to engage in the kinds of asset transformation traditionally accomplished through banking and more recently mimic through securitization methods. These are transformation of credit, maturity, and liquidity. The vehicles and the players may be different than in the past. But stripped down, the economics will be the same.

What is the role of banking regulation in this process? It is now widely recognized that Basel 2 created strong incentives for the adoption of the "originate to distribute" model by banks and for their heavy use of securitisation. Basel 2.5 tries to reverse these incentives by imposing much higher risk weightings on securitized assets.

However, much higher regulatory capital minimum give an incentive to move activities genuinely off balance sheet quite probably through non-bank entities . As has been emphasized by some regulators (e.g., Paul Tucker of BOE) this implies a significant systemic risk; however, recent regulatory changes in the US or Europe do relatively little to address this.