

Federal Financial Analytics, Inc.



**Strategic Landscape:
Policy Challenges to Bank Capital-market Activities**

Prepared for

ABASA

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The Collateral Collision

- High-quality assets (HQAs) of as much as \$4 trillion are needed to meet OTC-clearing requirements.
- Additional need for HQAs to meet capital, liquidity, other requirements, pushing demand well into levels affecting ability to comply with these rules.
- Unintended effects of these HQA requirements could also lead to incentives for higher-yield/risk holdings, greater market volatility due to bank need to hold favored HQAs (procyclical incentives under stress), and distorted market for high-quality assets not so designated by bank regulators (e.g., munis, certain equities, etc.).
- HQA demand comes at the same time as the FRB contemplates QE3 exit and rates rise.
- Additional complications in the U.S.: MMF reform that could hike demand for USG/agency paper and GSE reform that dries up new-issue agencies

Decision-Points

- What is cost of bulking up on HQAs to meet all rules? New source of untenable IRR, market risk?
- Is compliance w/all rules viable without muni, fixed-income, broader market distortions? If not, how should rules be revised?
- If collateral and other HQA demands starve banks of these assets, what is impact on financial intermediation? Capital arbitrage? Derivatives, related activities transit to shadow entities?
- Can securities-financing transactions handle enough collateral transformation to insulate markets from adverse impact? How do pending FRB/global repo rules affect SFT-industry capacity, especially at banks? Are incentives for SFT exit into the shadows exacerbated?

Specific Strategic Challenges

FedFin Issues and Forecast

U.S. Capital Requirements

- Leverage: Will go up likely based on both on/off-balance sheet assets and – less likely – IFRs asset measurements. Key: Will leverage rise in tandem with Basel III final rules or be separately proposed in U.S.? What is the impact of higher leverage vis-à-vis risk arbitrage, shadow-bank competitiveness – has industry well developed this point? If leverage rises, how should risk-based capital rules be adjusted?
- Market-Risk: The Basel Committee is continuing to build out the “fundamental rewrite” of the trading book. How will this work in concert w/other capital changes, specifically in the U.S.? Do new benchmarks/limits on models undermine risk sensitivity, competitiveness to the point at which unintended consequences ensue?
- Broker-Dealer Rules: FRB is determined to hike capital for b/d subsidiaries in BHCs, fighting now with SEC re how to do. Most likely: top-down added capital for U.S/FBOs with b/d subsidiaries, especially if other FFT reforms prove complex, delayed. Has industry developed key analytics re differences between b/d and bank risk?

SIFI Resolution

- Living Wills: Biggest BHCs under strong pressure and one or more likely to be required to restructure following 10/1 submissions. Are resolution plans designed with this in mind? How are ambiguities of single-point-of-entry/automatic-stay concerns resolved?
- Bail-in Debt: FRB will shortly issue NPR laying out how much long-term unsecured debt BHCs with assets over \$50B and certain FBOs must issue to make workable the FDIC’s single-point-of-entry resolution protocol. Current estimate: bail-in debt = Basel Tier 1 capital, raising serious market, cost implications. Also unclear if this requirement promotes orderly resolution or exacerbates contagion risk. If bail-in debt proves a no-go, U.S. will revisit current resolution regime, raising specter of TBTF, break-up demands, etc. What is industry view here?

Volcker

- Agencies still in stalemate. Likely: revised NPR. Desired shape of next NPR?

Extraterritoriality

- CFTC at stand-off pre 6/20 and 7/12 decision points.
- Congress unlikely to act despite strong support in House for Garrett bill. Does this rule combine with others to undermine harmonized global framework? If so, what does industry want in the U.S.?

FBO Rule

- FRB determined to finalize largely as proposed. Again, are global rules falling apart? If so, how to craft harmonized global framework? Trade talks?

GSE Reform

- Showing signs of real momentum, although Senate and House so far taking widely different approaches.
- Senate: establishes backstop for GSE successors, creating opportunity for banks to issue, guarantee RMBS w/backstop.
- House: GOP firmly opposed to any federal role. Want new rules for RMBS securitization, maybe greater Ginnie role in liquidity crises and more use of covered bonds.