SIFMA Insights:

Prudential Regulation Conference Debrief

June 2019

Key Takeaways

Recently, SIFMA hosted its annual Prudential Regulation Conference. With a day of presentations and events and around 200 attendees, we gained insights into top-of-mind topics for market participants. Inside this note, we recap just some of what was seen and heard, including: the intersection of prudential regulations and markets; time to revisit CCAR's approach to the trading book; and unintended consequences for markets.

Contents

The Intersection of Prudential Regulations and Markets 3
A Conversation with SEC Commissioner Hester Peirce & CFTC Commissioner Brian Quintenz 3
Time to Revisit CCAR's Approach to the Trading Book 5
Unintended Consequences for Markets 6
Reference Guide: Prudential Regulations and Regulators 8
Reference Guide:The Spider Web of Regulations 9
Author 10

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The Intersection of Prudential Regulations and Markets

In the aftermath of the global financial crisis, regulators and legislators across the globe began developing new regulations and laws to improve the safety and soundness of the global financial system and internally protect their own nations' economies and financial markets. We ended up with a two-track system: (a) global standard setters recommended a set of high-level policies, regulations and reforms to repair the global financial system and to maintain the global flow of capital, as well as encouraging consistent implementation of these policies across jurisdictions to create a level playing field across countries and regions; and (b) countries (or regions in the case of the EU) began turning global recommendations into their own regional and national laws and regulations, some of which followed global recommendations while others added additional regulatory requirements (ex: gold plating, ring fencing). All of which were implemented at varying paces.

Markets ended up with a spider web of regulations across the globe, some of which are duplicative or even contradictory. This includes a lack of harmonization within the U.S. across prudential (Fed, FDIC, OCC, etc.) and markets (CFTC, SEC) regulators. While prudential regulations (capital rules, SLR, etc.) are implemented at the bank holding company level, these same banks run the largest broker-dealers, which serve a critical role in making capital markets function efficiently as the intermediaries to a multitude of transactions. Prudential regulations meant to ensure the safety and soundness of financial institutions have, instead, created challenges to the efficient running of markets, particularly under stress conditions.

Market participants have expressed concerns that regulations have forced firms to exit businesses or reduce their engagement in select markets. And the conversation around regulatory recalibration and harmonization – whether tailoring regulations by risk profile, eliminating ring fencing and gold plating, or preventing overlapping or contradictory rules – has gone on for years. It is now time (or overdue time) to act, with a call to: (a) undergo an analysis of regulations and the impact on market efficiency, i.e. unintended consequences; (b) assess the current market environment versus where markets were when rules were written and implemented several years ago; (c) consider the everyday impact on markets, not just prepare for stress environments; and (d) propose changes to reverse the adverse effects of the original rules without releasing focus on ensuring financial stability.

A Conversation with SEC Commissioner Hester Peirce & CFTC Commissioner Brian Quintenz

This theme was highlighted at our prudential conference when CFTC Commissioner Brian Quintenz and SEC Commissioner Hester Peirce sat down for a fireside chat at our conference to discuss the impact of prudential regulations on markets. One area identified as having significant effects on capital markets was the SLR. It was "sold as a simple, remote backstop", which would only come into effect if other regulatory requirements failed. This is not the case, as it has already forced firms to exit businesses in benign market environments. And this is in (some) markets which have already undergone substantial consolidation. Commissioner Quinten indicated walked us through some of the CFTC's numbers:

- The number of CFTC registered Futures Commission Merchants (FCM) has dropped to 50 from 100
- In futures markets, the top 5 FCMs represent 50% of the markets, while the top ten hold a 75% share
- In swaps markets, the top three registered dealers represent 50% of the markets, while the top seven hold a 90% share (and are all under prudential regulatory standards)

This decreases competition and the number of firms available to act as intermediaries (this becomes particularly worrying under times of market or economic stress, as there will be less players available to facilitate capital markets operations). What is concerning to some market regulators is that many of the prudential regulations which have impacted markets are not risk based or data driven.

Another theme from panelists was the need for regulatory harmonization – across regions, between prudential and markets regulators and amongst market regulators themselves. It is important for regulators to work together, sharing ideas and developing strong relationships that will make it easier for all to navigate times of market stress. However, some regulators are "bank centric and do not always appreciate the value of capital markets". Commissioner Peirce noted the SEC has a "regulatory framework for markets which is appropriate" and enables full functionality of markets (ex: hedging, "healthy" risk talking activities, etc.). The key to harmonization is communication early and often and working together to get regulations right.

Of note, this is not the first time the CFTC has weighed in on what is normally deemed territory of prudential regulators: in February, the CFTC submitted a comment on the notice of proposed rulemaking issued by the OCC, Fed and FDIC to implement a new approach for calculating the exposure amount of derivatives contracts under the agencies' regulatory capital rules; and in May, outgoing CFTC Chairman Christopher Giancarlo sent a letter to the Fed's Vice Chair for Supervision Randal Quarles concerning implementation requirements for initial margin on uncleared swaps. Additionally, CFTC Chief Economist Bruce Tuckman has developed a metric for measuring the (true) size of risk in swaps markets called entity-netted notionals (ENN). The premise is that by properly sizing the total market, the conversation changes around sizing risk and therefore regulators can re-examine how regulatory thresholds are set. (For further details, please see our joint note with the Futures Industry Association (FIA), "Regulatory Recalibration & Industry Collaboration: Key Themes from the Asset Management Derivatives Forum".)

These examples highlight the increased importance placed by market participants – including regulators – on improving harmonization between prudential and markets regulators in order to ensure markets continue running efficiently.

Time to Revisit CCAR's Approach to the Trading Book

Why is it time to revisit CCAR, in particular the GMS? The risk profile of capital markets has changed significantly since 2008. There are new regulations to ensure safety and soundness – LCR, Volcker, securitization rules, etc. – and capital markets participants themselves are utilizing tools to minimize risks (and therefore costs, whether it be in capital charges or costs to trade/clear), such as seen with the increase in cleared derivatives. Additionally, financial institutions are in a much better risk management position to analyze and monitor their stress exposures across the entire firm's portfolio versus pre-crisis times. Post crisis, the focus was to build up capital to enhance the resiliency of the financial system. Now CET1 is up 71% since 2009 for the CCAR firms and the average CET1 ratio is 11.8%, well above the 7% minimum requirement and even greater than the maximum regulatory requirement inclusive of the highest G-SIB surcharge. Markets, firms and capital buffers have changed, yet the test has not. Nor has there been a reassessment of CCAR/GMS since the start of the test.

While CCAR is built around assessing a nine-quarter time frame across varying scenarios – which have continually increased in the severity of macroeconomic shocks – the GMS is an instantaneous shock to the trading book applied on top of the CCAR scenarios. This in itself is open for discussion, as firms must take a shock to the trading book with no corresponding impact assessed on the balance sheet or RWAs. Results of the shock are "velcroed" into the losses in the first quarter, with the additional element of a major counterparty default added on top. Market participants view the application of GMS and its impact on the final capital deployment result in CAAR as "inherently flawed". Capital allocation is not a one-day decision. Boards assess capital deployment strategies – which includes reinvesting in one's own company over distributions to shareholders – on a holistic, longer term level.

Panelists indicated regulators and the industry need to migrate from a one-day binding constraint to assessing overall risk profiles and appetites. Additionally, panelists discussed the inconsistencies around the inputs into the GMS. The equity shock was stable at a ~28%-29% decline through 2016, and then began jumping around in a ~10% range. For U.S. Treasury rates, there is significant volatility in the direction (up, down) of the shocks. In corporate bonds, the shock to B-rated bonds was 1,478 bps. Yet, the worst decline ever experienced was 1,325 bps, and that was during the global financial crisis.

In other words, CCAR and, in particular, the GMS have moved out of reality with how markets function. Market participants note that it is time to reassess the GMS, bringing to light the lack of transparency around creation and application of the shocks and the severity of the magnitudes of the shocks (among other factors).

SIFMA & Members Analyzing CCAR's Current Treatment of the Trading Book

CCAR's framework largely reflects the decisions made during the rapid development of SCAP a decade ago, when supervisors did not have the luxury of time to study or debate alternatives. In no other area of the CCAR process is this more evident than in the treatment of trading book assets. Despite millions of pages of new rules and guidance including sweeping changes to the Basel Committee's global accord which have drastically changed the risk profile of the trading book, there has been almost no change to the supervisory approach for these asset types. SIFMA with some of its members has initiated our own evaluation of CCAR's current treatment of the trading book with the objective of identifying areas for suited for enhancements given the shortfalls of current approaches. Moreover, our study will offer some rationale alternatives which are supportive of the supervisory goal of stress testing. Our study will be available in late June. Please see more details here: https://www.sifma.org/resources/news/left-untouched-for-a-decade-its-time-to-revisit-ccars-approach-to-the-trading-book/

Unintended Consequences for Markets

We highlight other key regulatory requirements that have or may lead to unintended consequences for the efficient running of markets:

- The State of Prudential Regulations – Market participants believe prudential regulators are committed to not just completing but also rethinking the work started years ago. Financial regulations have moved beyond double counting: (1) the belt is represented by capital requirements; (2) the suspenders are represented by CCAR; and (3+) then there are multiple side elements like the GMS, which was compared to a regulatory "noose" (it keeps one's head up but is confining). Cumulatively, these elements create much higher capital levels than intended, which has unintended consequences on the functioning of capital markets. No one is disputing that capital markets can impact the safety and soundness of financial institutions and the financial system, meaning prudential regulators have a role to play. With jurisdiction over markets, market regulators have a role as well. The industry needs coordination, or a balance if you will, which can lead to the resolution of inherent tensions between regulations and the ability of financial institutions to provide liquidity and support the economy.

- A View from the Fed – To set the scene the Fed's General Counsel Mark Van Der Wide quoted figures showing that the banking system is doing well: capital levels are ~2x pre-crisis levels; liquid assets are ~3x pre-crisis levels; wholesale funding reliance is down by ~1/3 pre-crisis levels; firms are more resolvable; and FBOs have simpler local structures. Given this, the Fed is focused on preserving the general core elements of reforms (capital, liquidity, stress tests) while improving the regulatory framework (increase transparency, tailor by risk profiles). One example is the Fed is striving to increase the transparency, simplicity and predictability of stress tests by finalizing a way to provide more detail on supervisory loss models. That said, when asked if the Fed is acting as a market regulator, Van Der Wide indicated the Fed's function is to ensure the safety and soundness of markets and promote financial stability. This has led the Fed over the last decade to "work more and more" with market regulators.

- Prudential Regulations Impact on Liquidity – The premise is that the cumulative effect of regulations has negatively impacted market liquidity. The Volcker Rule, capital rules, CCAR, LCR, NSFR, SLR, etc. have created balance sheet constraints (dealers hold less inventory/supply) and forced liquidity providers or market makers to exit markets (less intermediaries). Additionally, IHC requirements for FBOs impact their local broker-dealers.[1] This makes the cost (of regulations)-benefit (increased revenue or market share) analysis all market participants are undertaking in today's regulatory environment much more "dramatic" for FBOs. Further, the elimination of the longstanding deference to home country regulations for foreign firms operating in local markets could create a slippery slope. Other regions could then apply their own add-on regulations, which could decrease cross-border activities or at least increase costs to transact across borders. Market participants indicate it is too risky to breach regulatory requirements. Firms would get hit

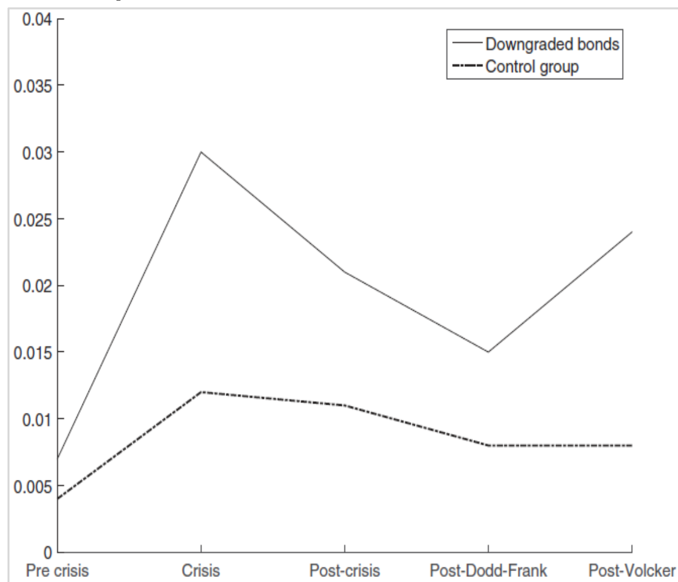
[1] Please see: https://www.sifma.org/wp-content/uploads/2019/04/SIFMA-Insights-The-Importance-of-FBOs-to-US-Capital-Markets.pdf

with a penalty or be forced into a higher G-SIB bucket (which would increase the cost of capital). This has led firms to act “conservatively”, despite best efforts to continue to serve clients.

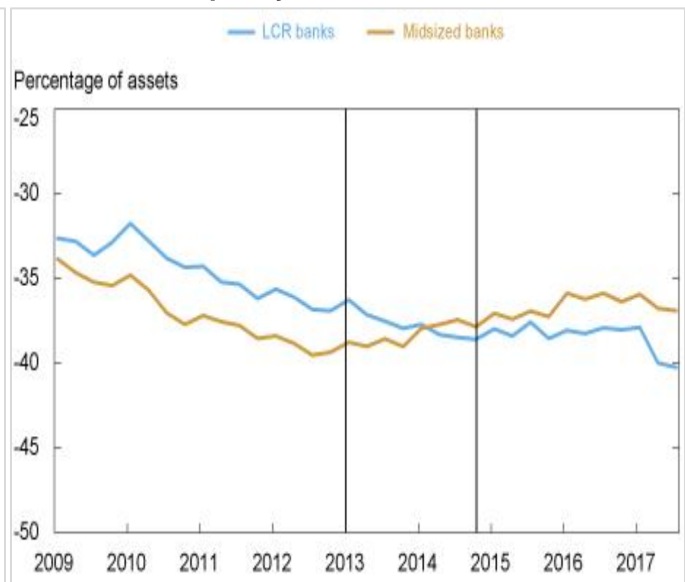
While market participants have shared qualitative examples, the challenge remains how to isolate and quantify the impacts for regulators. Looking at academic and economic studies, we analyze the following empirical evidence:

- (Left) The liquidity provision by Volcker-affected dealers dropped during post-Volcker stress times and was not compensated enough by non-Volcker-affected dealers to balance the decline
- (Right) LCR banks reduced liquidity creation more than midsized banks

Price Impact



Reduced Liquidity



Source: (left) Jack Bao, Maureen O’Hara & Xing (Alex) Zhou, The Volcker Rule & Corporate Bond Market Making in Times of Stress, 130 J. Fin. Econ. 95 (2018); (right) Roberts, Sarkar, Shachar, Bank Liquidity Provision & Basel Liquidity Regulations, Federal Reserve Bank of NY, June 2018
Note: pre crisis = 1/1/06-6/30/07; crisis = 7/1/07-4/30/19; post crisis = 5/1/09-7/20/10; post DFA = 7/21/10-3/31/14; post Volcker = 4/1/14-3/31/16

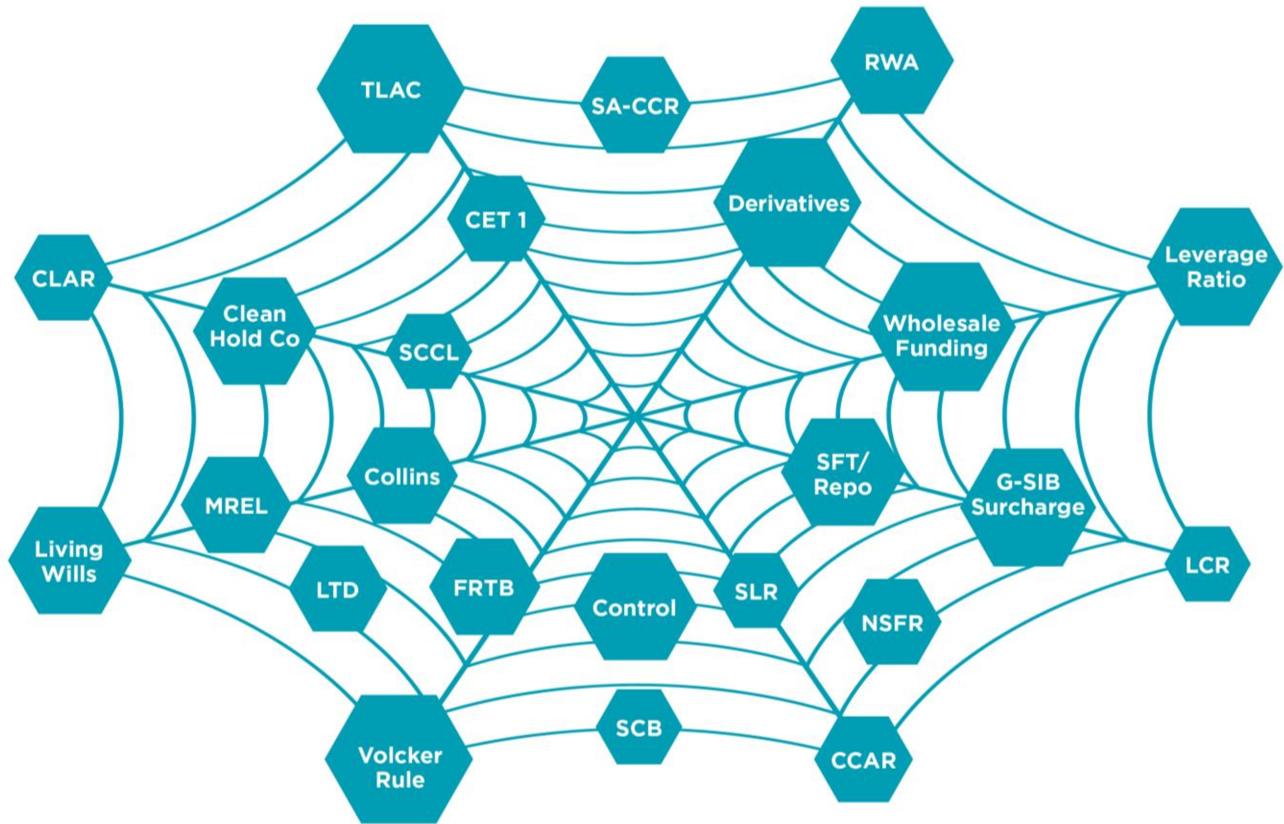
Reference Guide: Prudential Regulations and Regulators

Terms to Know

Regulations and Regulatory Terms	
ASF	Available Amount of Stable Funding
AT1	Additional Tier 1 Capital
B3	Basel III
BHC	Bank Holding Company
BRRD	Bank Recovery and Resolution Directive
CCAR	Comprehensive Capital Analysis and Review
CEM	Current Exposure Method
CET1	Common Equity Tier 1
CLAR	Comprehensive Liquidity Analysis and Review
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DFA	Dodd–Frank Wall Street Reform and Consumer Protection Act
EAD	Exposure at Default
EMIR	European Market Infrastructure Regulation
FBO	Foreign Banking Organization
FRTB	Fundamental Review of the Trading Book
GDPR	General Data Protection Regulation
GMS	Global Market Shock
G-SIB	Global Systemically Important Bank
HQLA	High Quality Liquid Assets
IHC	Intermediate Holding Company
IM	Initial Margin
LCR	Liquidity Coverage Ratio
LEI	Legal Entity Identifier
LISCC	Large Institution Supervision Coordinating Committee
MiFID	Markets in Financial Instruments Directive
MiFID II	Markets in Financial Instruments Directive (revised)
MiFIR	Markets in Financial Instruments Regulation
MREL	Minimum Requirement for own funds and Eligible Liabilities
NCOF	Net Cash Outflows
NSFR	Net Stable Funding Ratio
PFE	Potential Future Exposure
QIS	Quantitative Impact Studies
RSF	Required Amount of Stable Funding
RWA	Risk-Weighted Assets
SA-CCR	Standardised Approach for measuring Counterparty Credit Risk
SCB	Stress Capital Buffer
SLR	Supplemental Leverage Ratio
SRMR	Single Resolution Mechanism Regulation
SSM	Single Supervisory Mechanism
T1C	Tier 1 Capital
T2C	Tier 2 Capital
TE	Total Exposure
TLAC	Total Loss-Absorbing Capacity

International Regulators	
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
FSB	Financial Stability Board
GHOS	Group of Central Bank Governors and Heads of Supervision
IOSCO	International Organization of Securities Commissions
AsiaPac Regulators	
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
RBA	Reserve Bank of Australia
CBRC	China Banking Regulatory Commission
CSRC	China Securities Regulatory Commission
PBC	People's Bank of China
HKMA	Hong Kong Monetary Authority
SFC	Securities and Futures Commission (Hong Kong)
RBI	Reserve Bank of India
SEBI	Securities and Exchange Board of India
BoJ	Bank of Japan
FSA	Financial Services Agency (Japan)
MAS	Monetary Authority of Singapore (Singapore)
European Union Regulators	
EBA	European Banking Authority
ECB	European Central Bank
ESMA	European Securities and Markets Authority
SRB	Single Resolution Board
AMF	Autorité des Marchés Financiers (France)
BaFin	Federal Financial Supervisory Authority (Germany)
FINMA	Swiss Financial Market Supervisory Authority (Switzerland)
NCA	National Competent Authority
NRA	National Resolution Authority
United Kingdom Regulators	
BoE	Bank of England
FCA	Financial Conduct Authority
PRA	Prudential Regulation Authority
United States Regulators	
AG	Attorney General
CFPB	Consumer Financial Protection Bureau
CFTC	Commodity Futures Trading Commission
FDIC	Federal Deposit Insurance Corporation
Fed	Federal Reserve System
FFIEC	Federal Financial Institutions Examination Council
FINRA	Financial Industry Regulatory Authority
FSOC	Financial Stability Oversight Council
OFR	Office of Financial Research
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission
USTD	U.S. Treasury Department

Reference Guide:The Spider Web of Regulations



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