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Association For Financial Markets in Europe

AFME Members' Briefing:
Impact of Regulation on Banks' Capital Markets Activities

Tuesday 24 April 2018

Michael Lever, Managing Director, Head of Prudential Regulation, AFME
Rick Watson, Managing Director, Head of Capital Markets, AFME
Nick Forrest, Director, Financial Economics, PwC
Pablo Portugal, Director, Advocacy, AFME

Outline of today's briefing

- 1. Michael Lever:

Why we wrote "Impact of Regulation on Banks' Capital Markets Activities: An *ex-post* assessment" and how we conducted the study

- 2. Rick Watson:

What significant changes did the report reveal?

- 3. Nick Forrest:

What were the drivers of the changes?

The five drivers, how we calculated them and what the results were

- 4. Pablo Portugal:

What next?

Our recommendations and advocacy plans

- 5. Q&A

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Why we wrote this report and how we conducted the study

Michael Lever
Managing Director, Head of Prudential Regulation, AFME

Why did we decide to commission this study?

- Timing was right
- Aim was to identify the role played by regulation – as distinct from other factors - in banks' balance sheet changes
- Study is different from what had gone before in two ways:
  - Most previous studies forward-looking and focused on a single regulation
  - Our study looks at what actually happened and covers all regulations
- Not a complaint against post-crisis regulation, which was a positive
- Intention is to encourage authorities to undertake further ex – post studies on regulatory impact

How did we do the study?

- 13 banks representing 70% of global capital markets activity
- Data obtained from external supplier Tricumen
- Selected years 2005, 2010 and 2016
  - 2005 sufficiently before the crisis
  - 2010 period after the crisis when new regulations beginning to be introduced
  - 2016 latest detailed data available
- Cross-checked findings against high level 2017 IB results
- Examined changes across 8 level one products and 22 level 2 products
- Then looked at 5 drivers of change
- No individual bank data was disclosed

What significant changes did the report reveal?

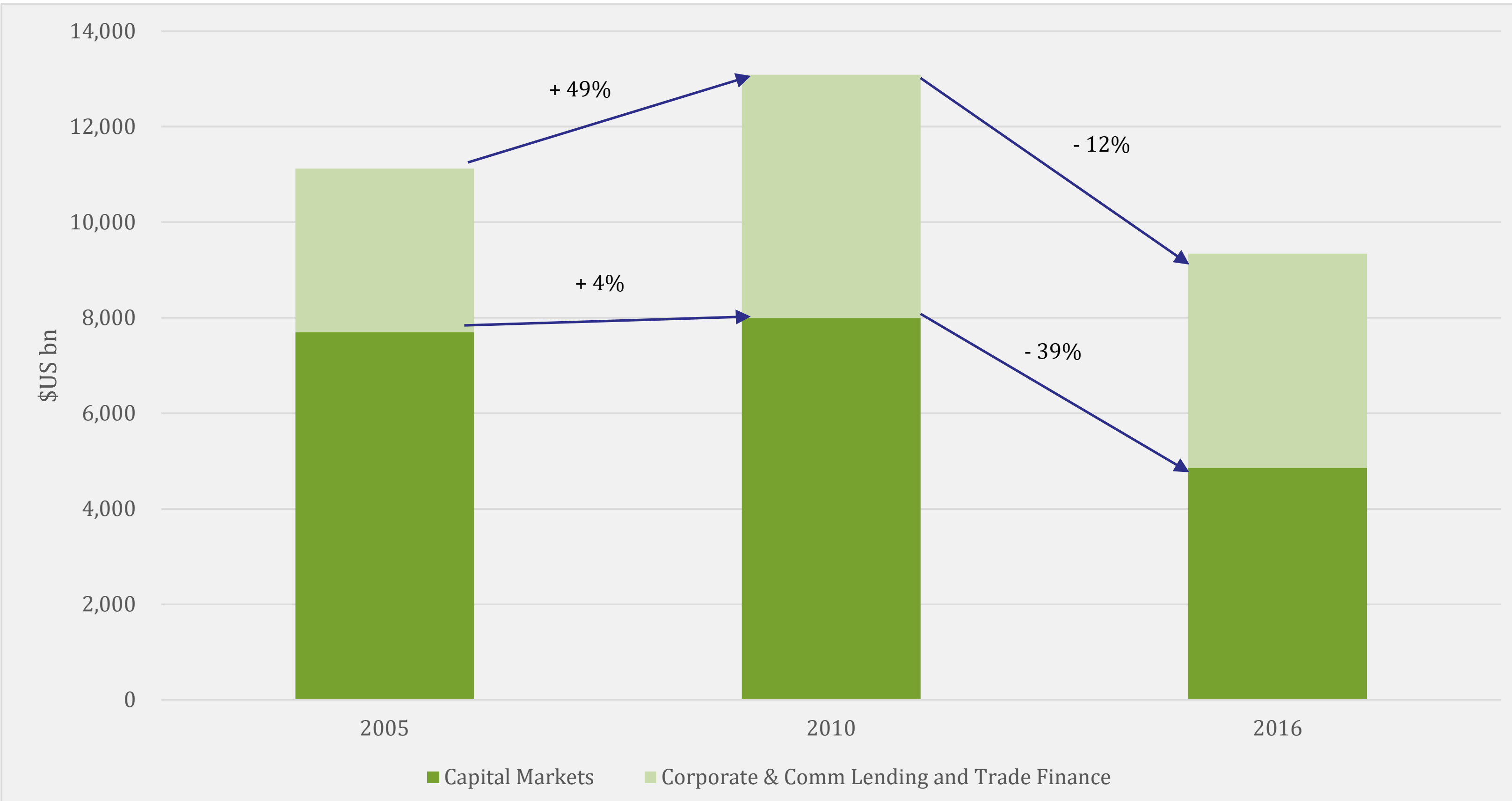
Rick Watson
Managing Director, Head of Capital Markets, AFME

Insights Revealed on Capital Markets Activities

- Analysis period sufficiently wide to cover pre and post crisis.
- Product areas analysed include rates, credit, securitisation, FX and equities, all including related derivatives positions
- Balance sheet impact is significant, with areas most significantly impacted highly sensitive to leverage and capital charges
- Although MiFID II/MiFIR impact is not included, it is clear that the impact of prudential regulations have to date been far more costly to banks in terms of ongoing cost than the impact of securities market regulations.
- This is also before implementation of NSFR and final Basel III

Sample banks' balance sheets have shrunk

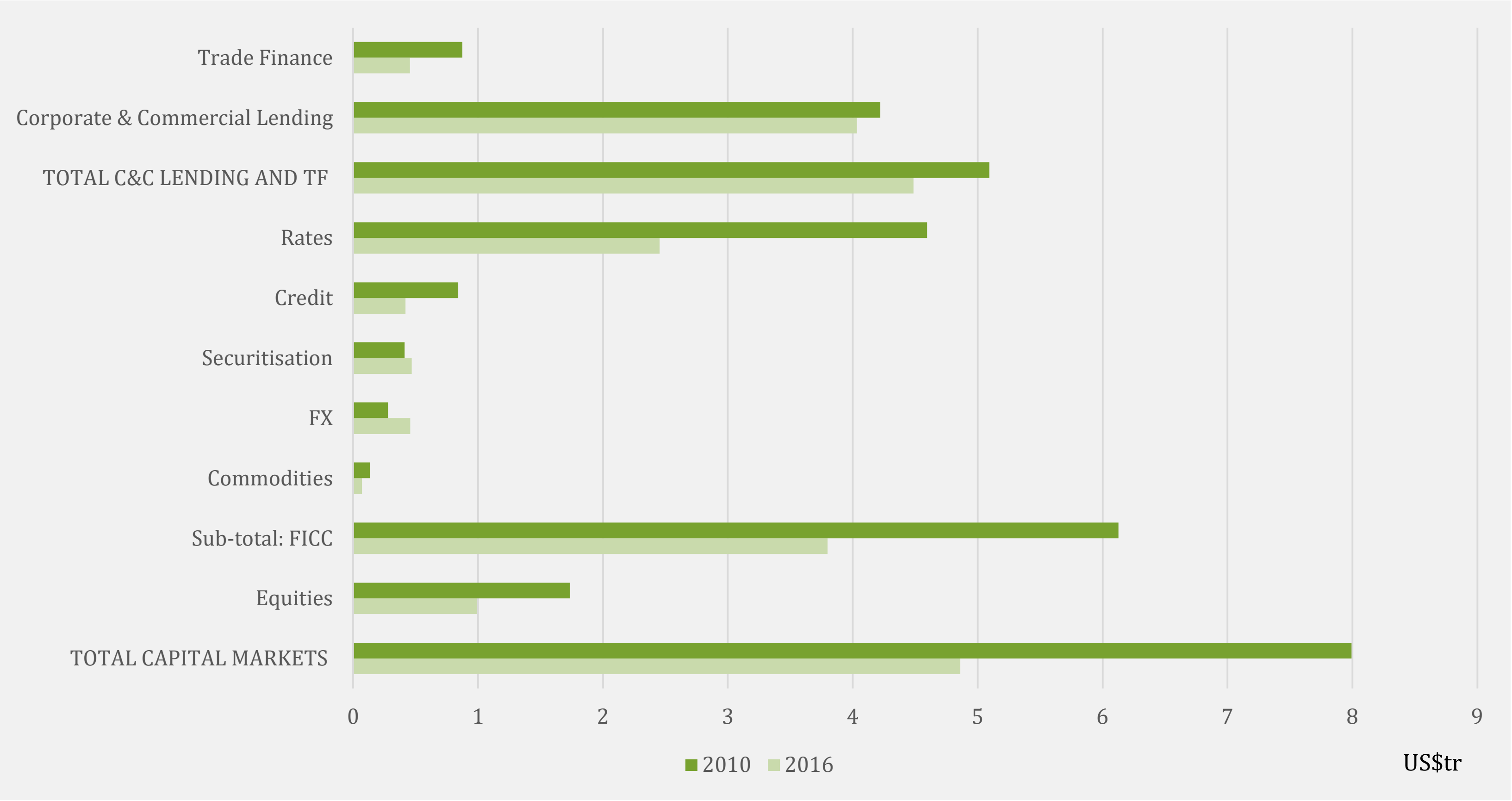
Change in balance sheets 2005 to 2016



Source: Tricumen/PwC analysis

Changes in balance sheet assets

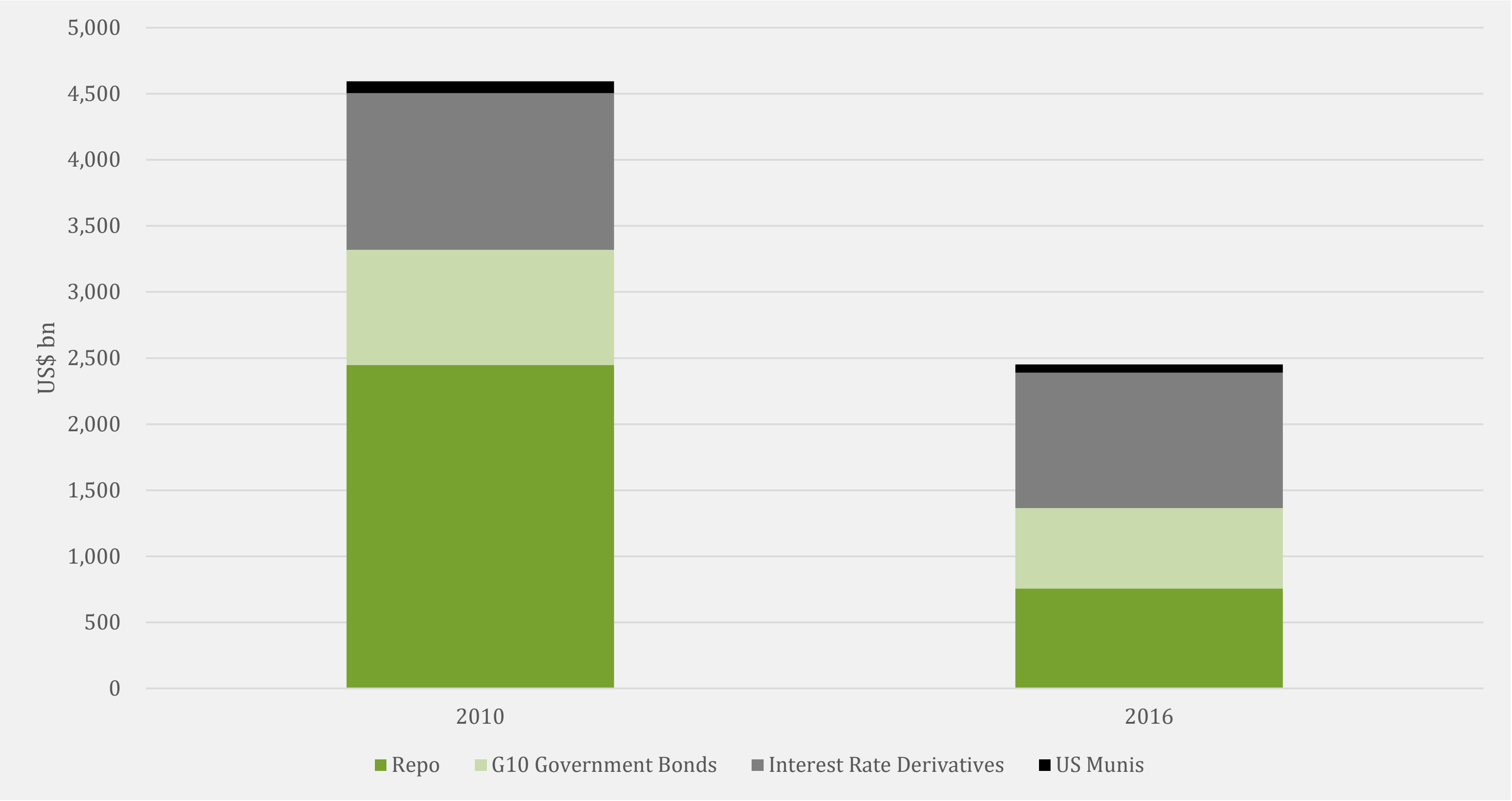
Change in balance sheets 2010 to 2016, by product



Source: Tricumen/PwC analysis

Changes in balance sheet assets

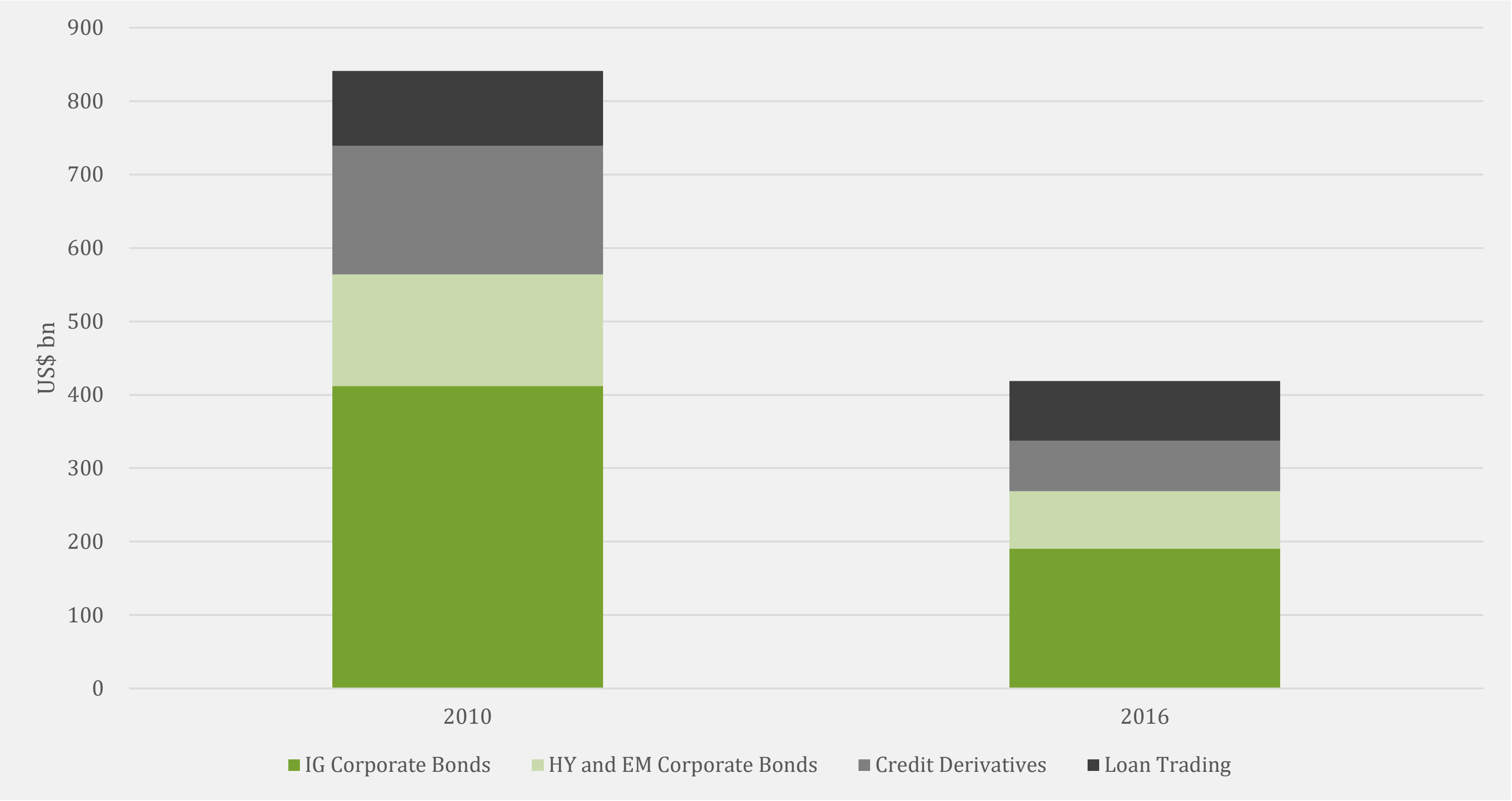
Change in rates products, 2010 to 2016



Source: Tricumen/PwC analysis

Changes in balance sheet assets

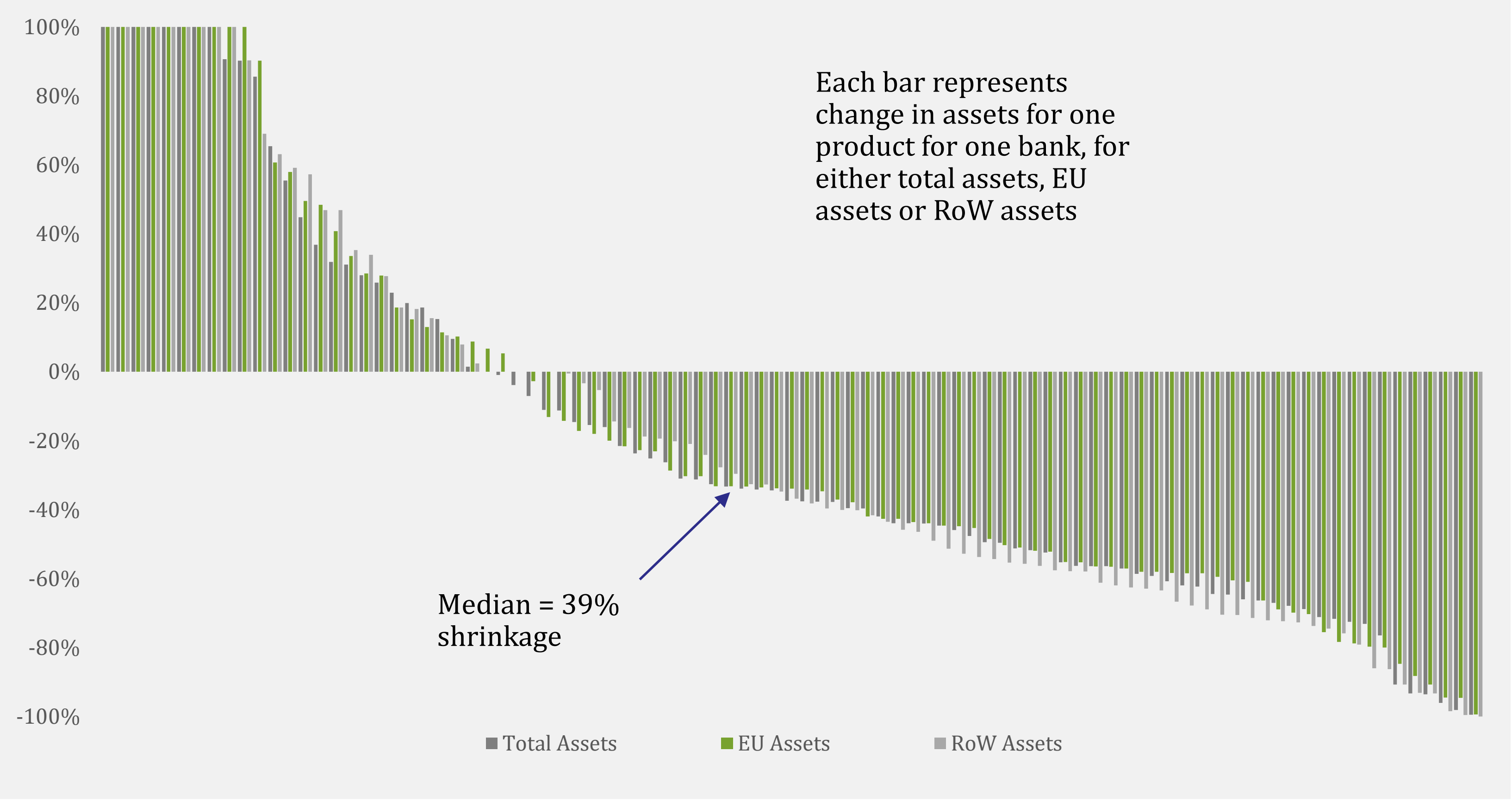
Change in credit products, 2010 to 2016



Source: Tricumen/PwC analysis

Changes in balance sheet assets

Change in balance assets by product, by bank (2010-2016)



Source: Tricumen/PwC analysis

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What were the drivers of the changes?

Nick Forrest
Director, Financial Economics, PwC

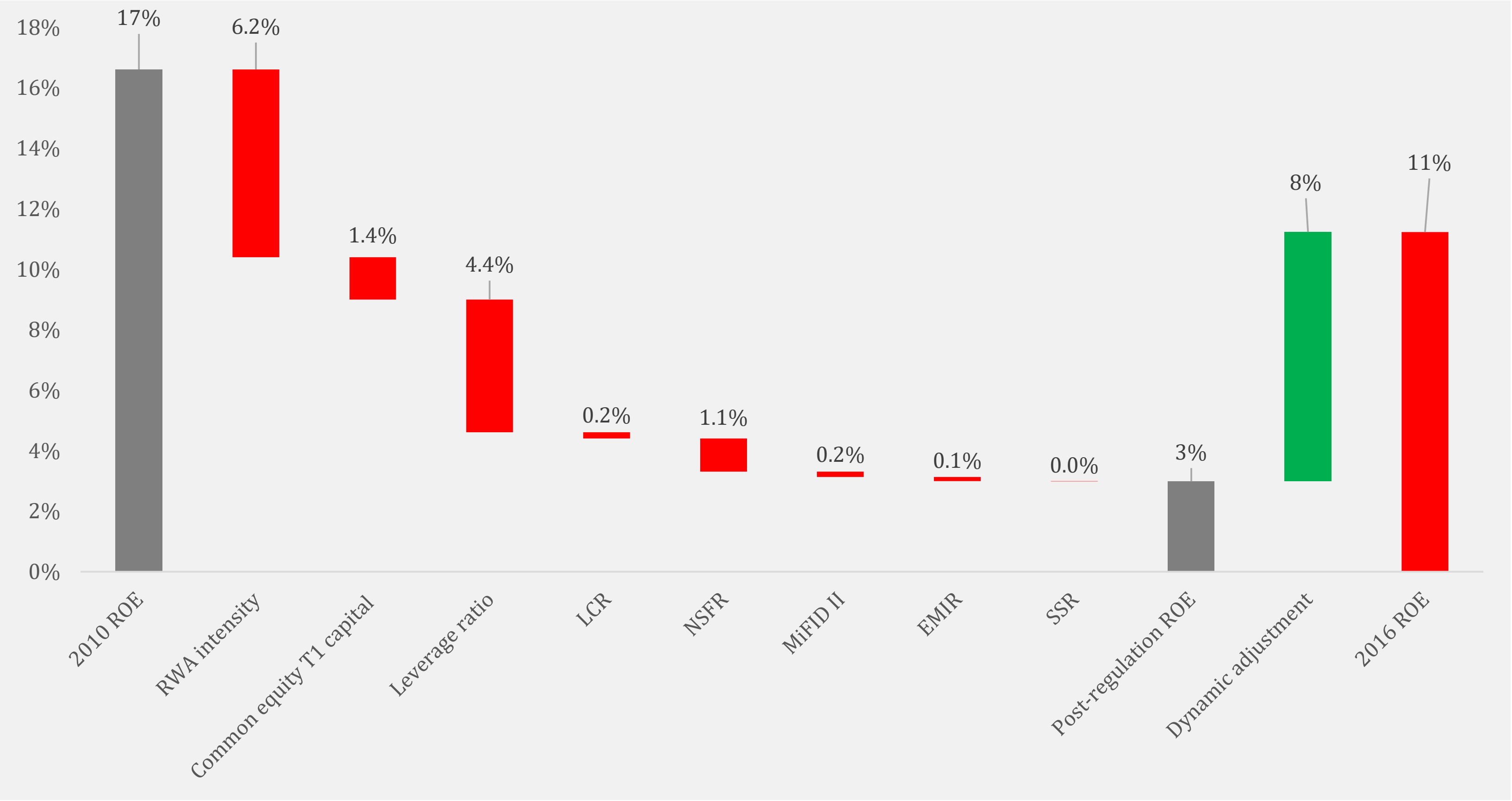
Driver of change (1a): Regulation

- Regulatory costs aggregated by product (= Regulatory impact driver)
- Includes capital, funding, liquidity and operational costs
- Applied to 2010 balance sheet

Regulation impact to 2016 (13 sample banks)	Total regulatory impact driver for total capital markets activity US$bn (per annum)
Risk-based capital and leverage requirements	33
Short-term liquidity requirements (LCR)	0.6
Long-term funding requirements (NSFR)	3
MiFID II / MiFIR (based on European Commission estimates)	0.5
EMIR (based on BIS estimates)	0.4
Short selling regulation (Based on EC estimates)	Negligible
Total	**c. $37 billion/year**

Driver of change (1b): Regulation

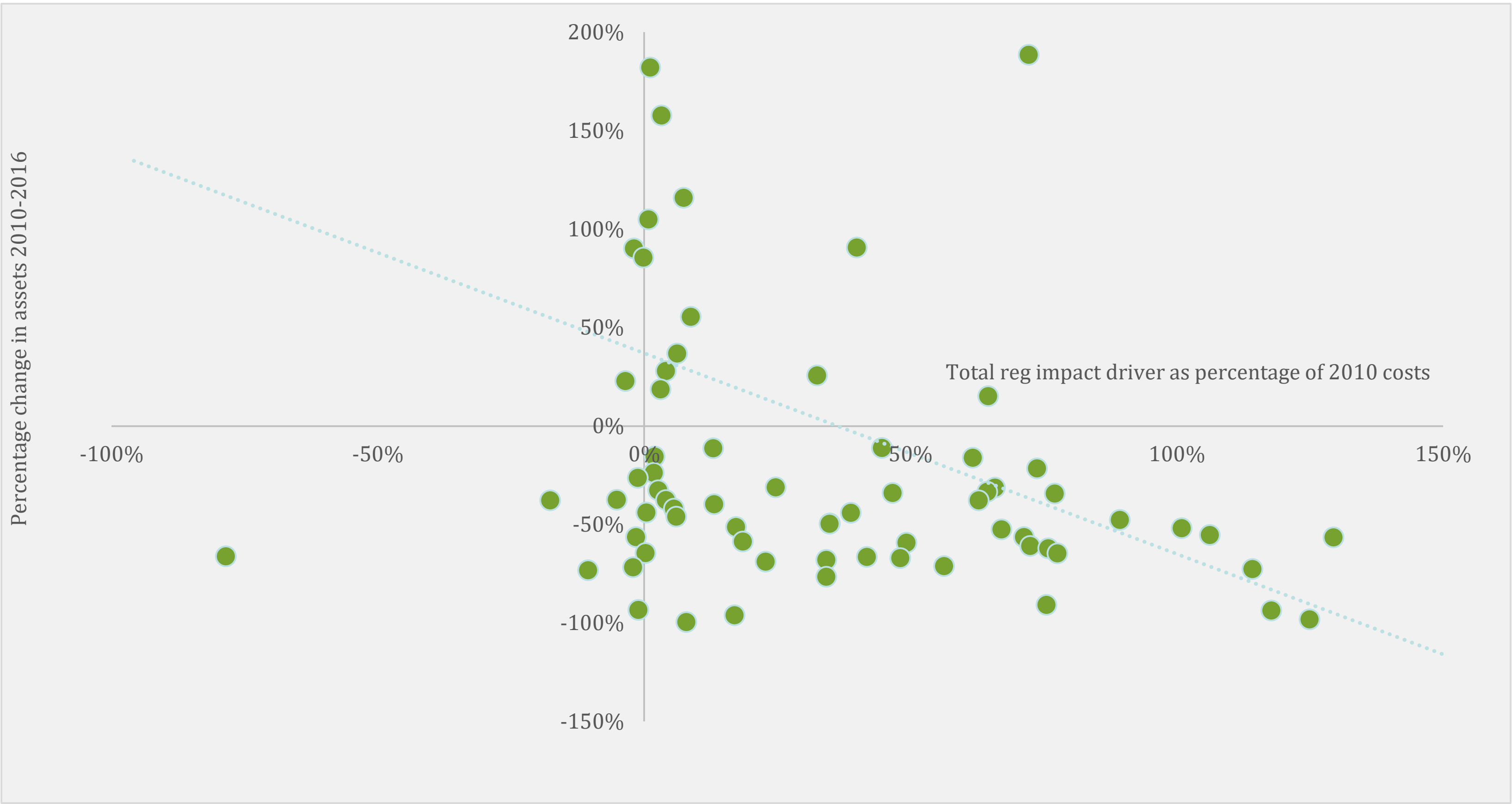
Regulation impacts ROE…which requires a commercial response



Source: Tricumen/PwC analysis

Driver of change (1c): Regulation

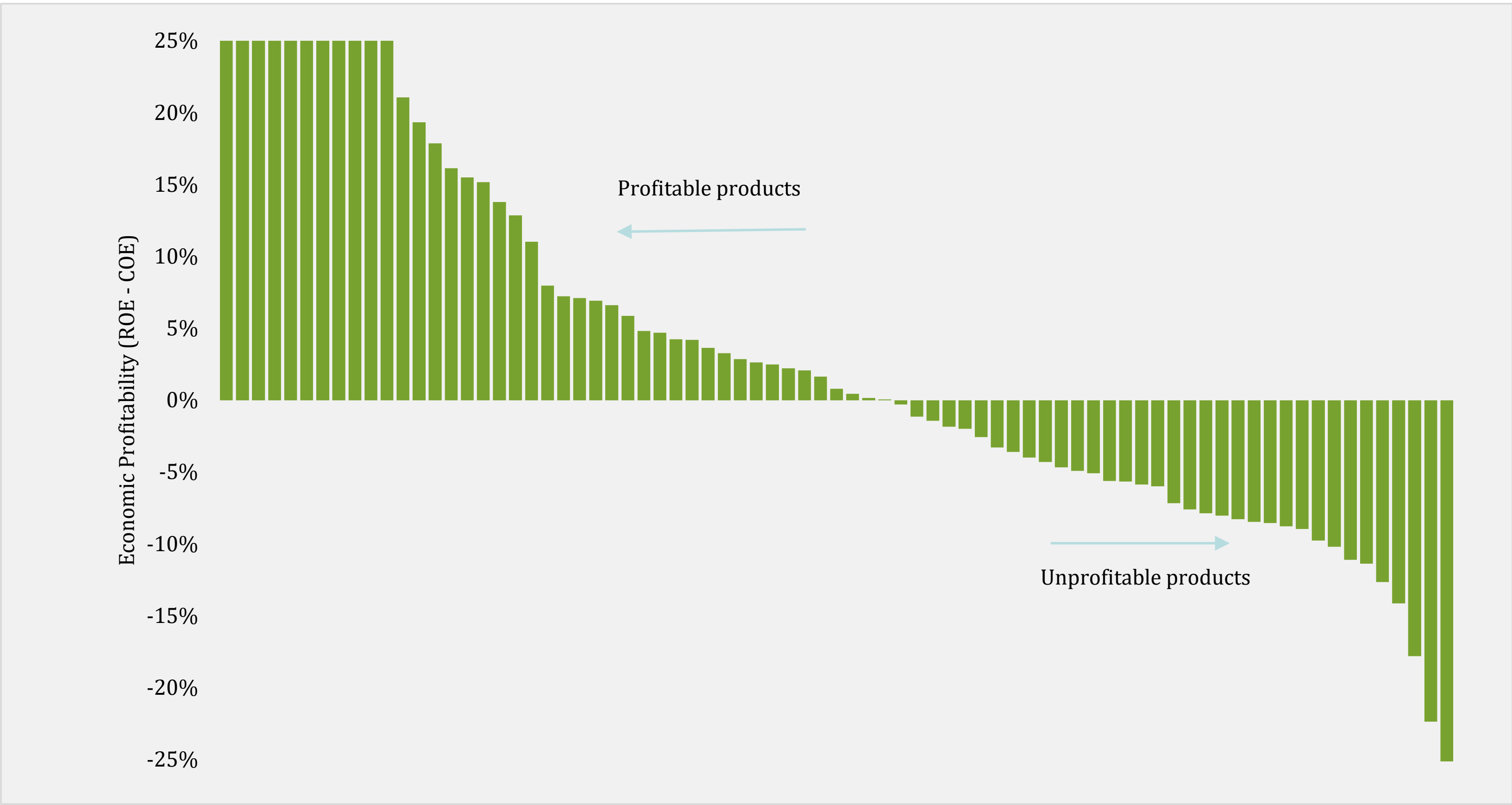
Relationship between regulation and change in assets (2010-2016)



Source: Tricumen/PwC analysis

Driver of change (2): Commercial performance

Variation in economic profitability, by bank, by product



Source: Tricumen/PwC analysis

Driver of change (3): Macroeconomics and sector wide trends

- Impacts all banks, and all products
- Includes wider macroeconomic trends (albeit growth over 2010 to 2016 was at or marginally below trend growth)
- Includes QE and low interest rates
  - These effects can be positive and negative (e.g. QE supports asset prices, but reduces volatility/liquidity; low interest rates depress margins, but reduce system-wide credit losses)
- Sector-wide cycle (linked to macro-economy and post-crisis recovery)

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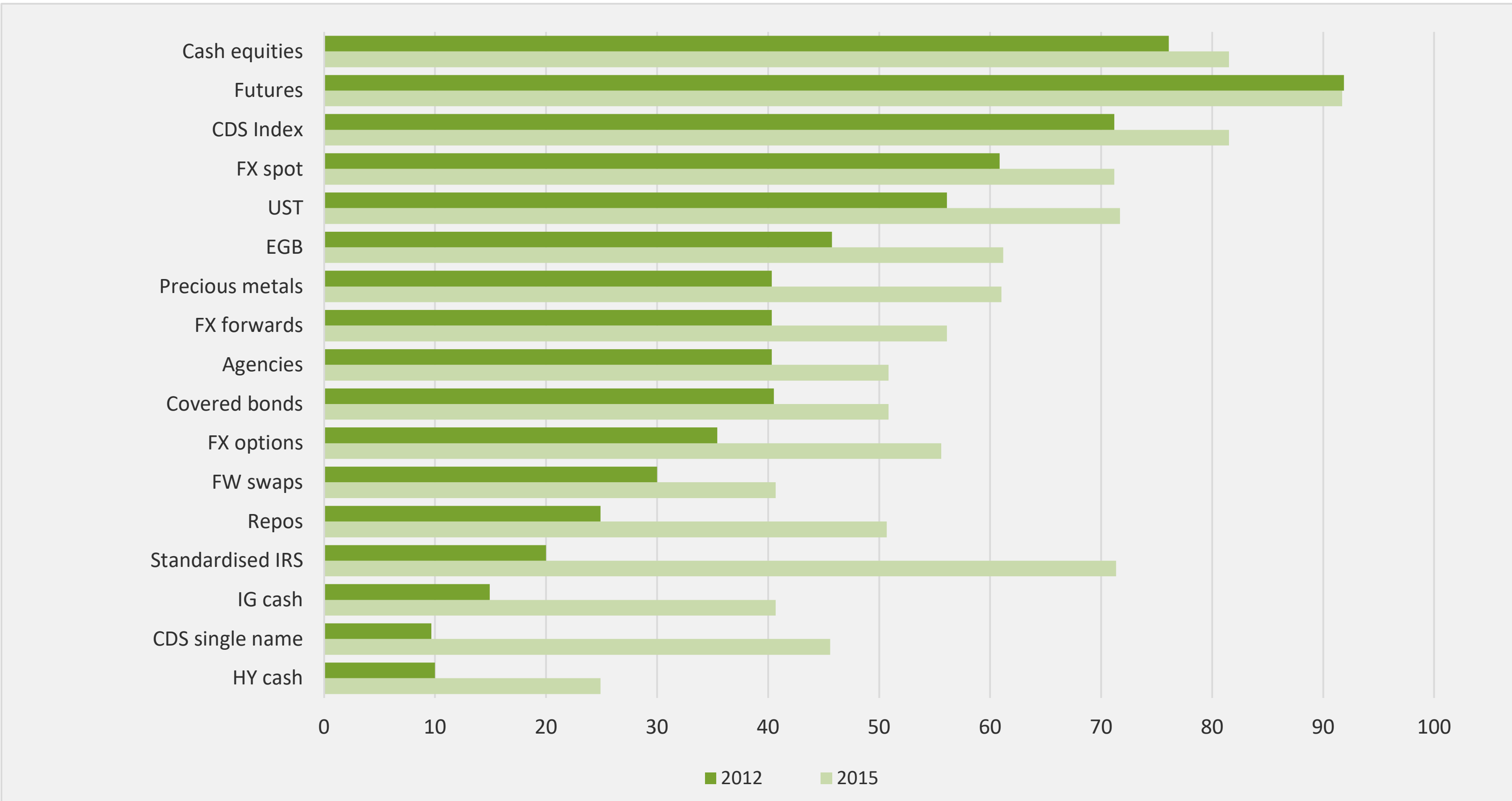
Driver of change (4): Technology

Change in electronification, by product



Source: *BIS, Greenwich Associates and McKinsey*

Driver of change (5): Bank-specific effects

- Some banks emerged from the financial crisis in better shape than others
- Some have pursued overarching corporate strategies, e.g.:

  (i) grow

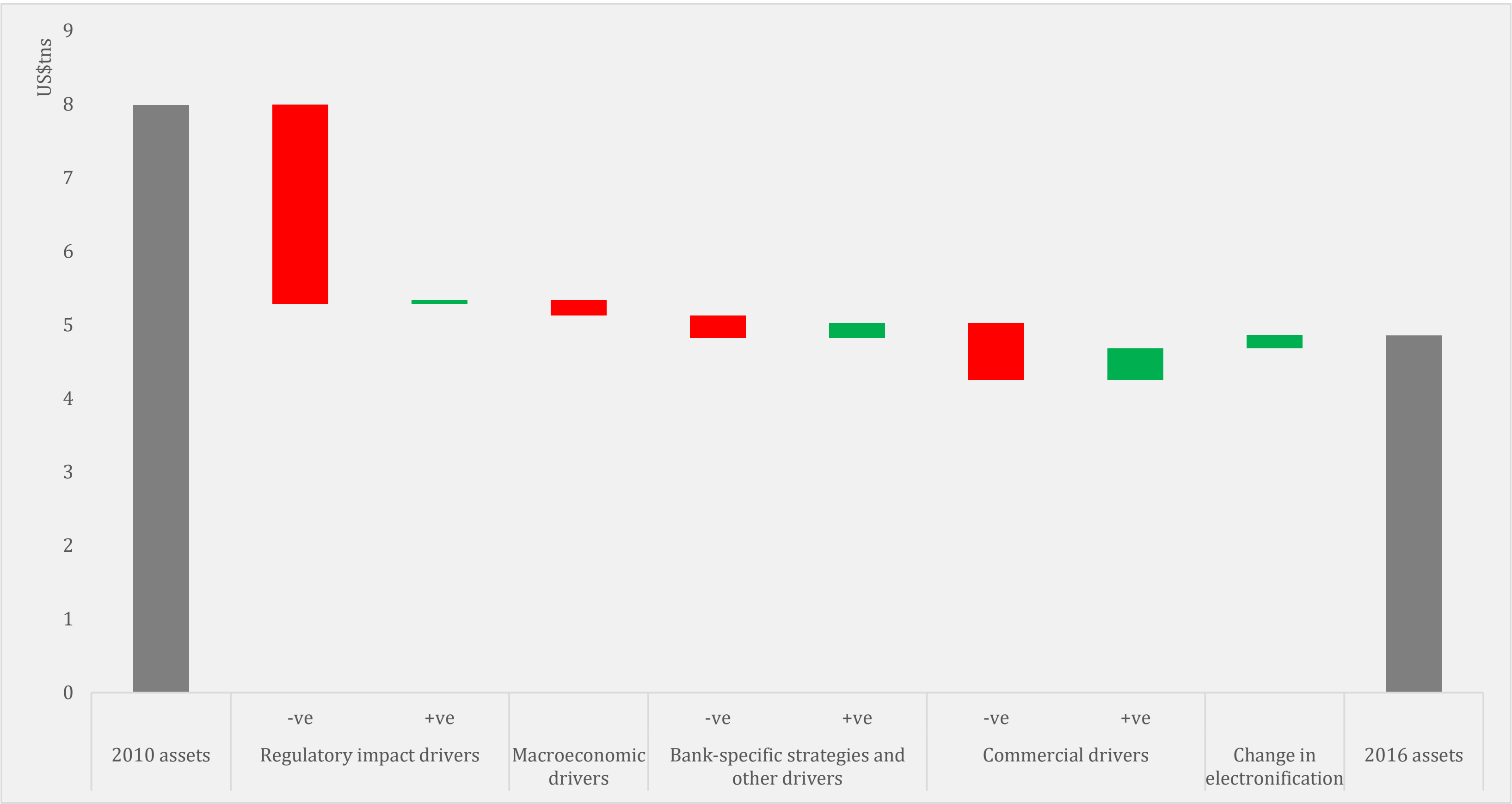
  (ii) shrink fast and re-grow

  (iii) delayed shrinkage

  (iv) continued shrinkage
- Variation in shrinkage across banks does not follow geographic headquarters (US/EU/SW)

Overall impact

Impact of 5 drivers in explaining shrinkage in assets (2010-2016)



Source: PwC analysis

In summary

- The aggregate annual regulatory cost that applies to capital markets activities across the 13 banks in our sample is estimated to be c. **US$37bn**, representing 39% of total capital markets expenses in 2016.
- The largest regulatory impacts are from **risk-based capital and leverage** requirements, which account for almost 90% of the total regulatory impacts.
- Regulation has driven a **14 percentage point** reduction in (pre-tax) capital markets return on equity (ROE) from 2010 to 2016 (from 17% to 3%) before banks' mitigating actions via deleveraging, cost reductions or repricing
- There has been a **39%** reduction in capital market assets over the period 2010 to 2016; concentrated in rates, repos and credit.
- PwC's regression analysis suggests that the regulatory driver alone accounted for about **two thirds** of the decline in capital markets assets across the sample between 2010 and 2016. Other factors such as macroeconomic trends, technology and banks' commercial performance also play a role.

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What next?

Pablo Portugal
Director, Advocacy, AFME

Assessing impacts on market liquidity & end-users

- How is the reduction in banks' capital markets capacity affecting financial markets and end-users?
  - Capital markets financing and risk management services to remain viable?
  - Higher costs for end-users? Changes in liquidity conditions?

- Authorities have begun to examine the effects of post-crisis reforms – particular focus on market liquidity
  - Papers by the IMF, CGFS, European Commission, IOSCO, BIS, US SEC and other central banks and national authorities
  - Signs of fragility in fixed income liquidity environment and a trend towards bifurcation

- Impact on development of a Capital Markets Union

Key recommendations

- Undertake further *ex-post* cumulative impact studies & examine:
  - How regulation impacts the economics for providers of primary and secondary market products and services
  - Effects on financial stability and the sustainability of banking services
  - Impact on market making – initial focus on capital, leverage, and liquidity requirements in affected asset classes
  - Unintended effects on intermediation or end-users (e.g. SME equity research)
- Understand the evolution of non-regulatory impact drivers
- Ensure appropriate calibration of key regulatory regimes
  - Risk Reduction Measures Package
  - MiFID II/MiFIR and other market structure/conduct regimes

Q&A

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Offices

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