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Fixed Income Special

Regulatory easing – a brave new world

Key points

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- Reflation expectations have been predicated on the hope for a pro-growth policy agenda centred on three main vectors: tax reform, infrastructure spending, and regulatory easing. President Trump kick-started the process on the regulatory front with an executive order on 3 February that directed the Treasury secretary to consult with regulators on how to go about fixing the Dodd-Frank Act to make sure existing laws align with the administration's goals.
- In the spirit of an overhaul (rather than a dismantling) through the guiding principle of ensuring that existing laws align with the administration goals and principles, we see the following portions of the current regulatory framework as particularly exposed to the administration's efforts: the Volcker Rule, CCAR and DFAST frameworks, liquidity and capital requirements for financial institutions (LCR, NSFR and TLAC), SEFs and the swap trading regime, and the fiduciary rule.
- On the **implications for rates**, we note a few themes:
 - a) **Increased liquidity conditions**, with a likely **decrease in the significance of liquidity events** and a **broader positive impact in the less liquid corners of the market**, like off-the-run issues.
 - b) A bias towards **bearish implications for rates**.
 - c) While increased levels of corporate issuance to meet TLAC and LTD requirements may be slightly bearish for spreads, structurally, **an environment where dealers are allowed to operate with larger balance sheets supports spread wideners**.
 - d) A bias towards further **tightening in bid/offer spreads for swaps**.
 - e) A bias towards downward pressure for intermediate and long expiries on the left side of the volatility grid.
- We offer some ideas of what regulatory changes could occur and their implications for the rates market. At present we do not know of specific regulatory changes and our effort is guess-work on possible changes. Our piece is not intended as regulatory advice. We are rate strategists and our effort is to analyse and anticipate any changes that could affect the rate markets.

A brave new world

The reflation move out of the US elections was supported by an expectation for action around three main policy vectors: tax reform, infrastructure spending, and regulatory easing. As we have argued in recent publications (see [here](#)), of the three policy vectors, perhaps the easiest to deliver on is regulatory easing. Indeed, there seems to be a broad consensus among Republicans on a need to ease regulatory pressure, and perhaps a feeling in some quarters that there is a roaring bull ready to be unleashed if only the regulatory chains that are tying it down were loosened somewhat. Here we offer some ideas of what regulatory changes could occur and their likely implications for the rates market.

The current regulatory framework and criticisms

In regards to financial markets and the banking system, most of the current regulatory edifice was put in place in the aftermath of the financial crisis, with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (aka Dodd-Frank) constituting the centrepiece of the new regulatory regime. Over its roughly 2,300 pages, the Dodd-Frank Act creates a number of new government agencies responsible for the implementation and oversight of its various provisions.

Seven core principles:

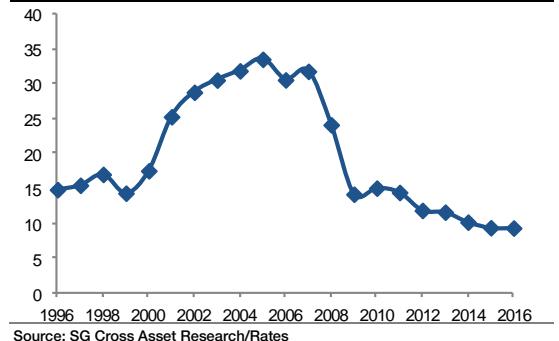
- 1) Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;
- 2) Prevent taxpayer-funded bailouts;
- 3) Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;
- 4) Enable American companies to be competitive with foreign firms in domestic and foreign markets;
- 5) Advance American interests in international financial regulatory negotiations and meetings;
- 6) Make regulation efficient, effective, and appropriately tailored;
- 7) Restore public accountability within federal financial regulatory agencies and rationalise the federal financial regulatory framework.

The promise to dismantle the Dodd-Frank Act was a prominent feature of the Trump election campaign, although more recently the headlines have described this process as an overhaul. Indeed, we find it more likely to see an overhaul of the recent regulation rather than a dismantling of the complete edifice. The process started officially at 9am on 3 February with an executive order (see [here](#)) that directed the Treasury secretary to consult with regulators on how to go about fixing the Dodd-Frank Act to make sure existing laws align with the administration's goals (which, from an economic perspective, we read broadly as spurring lending, job creation and growth), and to report back within 120 days of the date of the order. The order makes it the official policy of the Trump administration "to regulate the United States financial system in a manner consistent with" **seven core principles** (see box on left).

In a recent note (see [here](#)) our economists discuss the political process and economic implications of possible regulatory easing efforts. Here we focus on those portions of the current regulatory framework that we find more relevant for the rates space. In the spirit of an overhaul (rather than a dismantling) through the guiding principle of ensuring that existing laws align with the administration goals, we see the following portions of the current regulatory framework as strong candidates for some hits from the administration red pen:

1. **Volcker Rule.** The curb on proprietary trading was the most visible face of the Volcker Rule (see [here](#)), but the rule also **limits dealers' market-making desks' ability to hold inventory** at levels that meet reasonably expected near-term demand (RENTD). An unintended consequence of this has been a **general decline in liquidity conditions**, which is particularly significant in times of market stress, although there is evidence that non-Volker affected dealers have stepped in to provide some additional liquidity (see [here](#)). Indeed, the ratio of annual traded volume for US Treasuries versus the total outstanding amount, which we use as a proxy for liquidity, reveals a significant drop in liquidity conditions post-crisis (the effect is exacerbated when we exclude Treasury holdings by non-economic investors – see [here](#)). In a context of rising yields and expectations for a process of re-equitisation of portfolios (as we argued [here](#)), lower liquidity conditions may contribute to a significantly more volatile environment.

Graph 1. US Treasury liquidity ratio



2. **CCAR and DFAST.** The Comprehensive Capital Analysis and Review (CCAR) is an annual assessment (both qualitative and quantitative) by the Federal Reserve of the level of capital adequacy of large bank holding companies (BHC) to deal with periods of economic and financial stress (see [here](#)). Complementary to CCAR, the Federal Reserve also conducts the Dodd-Frank Act Stress Testing (DFAST), a forward-looking quantitative

The largest most systemically important financial institutions (**SIFIs**) are subject to the full range of regulatory and supervisory requirements. A second tier is composed of banking organisations with more than \$50bn in assets but outside the LISCC (the Large Institution Supervision Coordinating Committee portfolio), with a perceived lower level of systemic risk (see [here](#)). A third level of tailoring of regulatory and supervisory requirements is made for regional banking organisations, defined as those with total assets between \$10bn and \$50bn. The final tier includes banking organisations with total assets of \$10bn or less, which are not subject to DFAST or CCAR but are still under Federal Reserve supervision.

assessment of the sufficiency of capital levels to absorb losses and support operations in periods of adverse economic conditions. In its current format, the annual stress-testing exercise involves three scenarios (baseline, adverse and severely adverse). The tiering in this portion of the regulatory framework, as in other areas, ensures that the largest **most systemically important financial institutions (SIFIs) are subject to the full range of regulatory and supervisory requirements** (see box on left).

Criticism has concentrated on three main aspects. The first is the undue **burden that the current regulatory framework poses on smaller community banks**. Despite the tiering of the regulatory and supervisory oversight (see above), and recent measures aimed at reducing the regulatory burden of smaller banking organisations, the prevailing view seems to be that there is still work to do on this front. The second focus of criticism is related to the seemingly **arbitrary nature of some of the qualitative aspects of the assessment**. Finally, the third source of criticism has to do with how the “**too big to fail**” risk, which was a core objective of the regulatory framework, continues to persist.

3. **Liquidity and capital requirements** for financial institutions (LCR, NSFR and TLAC). Basel III addressed the shortcomings in the financial institutions’ regulatory framework that was exposed during the financial crisis. It focused on the levels of loss reserves that financial institutions are required to hold through three key principles:
 - a. **Capital requirements**: from 2015, a minimum of 6% tier 1 capital as a percentage of risk-weighted assets (RWAs), of which 4.5% are common equity tier 1 (CET1). The required CET1 capital ratio will increase to 7% from 2019 onwards (see [here](#)).
 - b. **Leverage ratio**: a minimum of 3% ratio of tier 1 capital to average total consolidated assets.
 - c. **Two required liquidity ratios**:
 - i. Liquidity coverage ratio (**LCR**): banks need to hold sufficient high-quality liquid assets (HQLA) to cover 30 days of total net cash outflows.
 - ii. Net stable funding ratio (**NSFR**): this requires the available amount of stable funding to exceed the required amount of stable funding over a 1y period of extended stress.

A substantial portion of the Basel III rules has been transposed into the US regulatory framework, with a more stringent formulation in certain areas, including a shorter transition period for implementation, and a more restricted range of assets that qualify as HQLA. For the eight largest SIFIs, the Federal Reserve has set the minimum leverage ratio at 6%, significantly higher than the Basel III minimum.

The total loss-absorbing capacity (**TLAC**) is designed to avoid the need for a government bailout in an insolvency scenario by requiring enough loss-absorbing capacity for globally systemically important banks (GSIBs) to be able to implement an orderly resolution (see [here](#)). It adds to a long-term debt (**LTD**) requirement, which can be converted to equity and used recapitalise these firms’ critical operations upon failure. For domestic banks, the standard sets: 1) an LTD amount of the greater of 6% plus its GSIB surcharge of RWAs and 4.5% of total leverage exposure; and 2) a TLAC amount of the greater of 18% percent of RWAs and 9.5% of total leverage exposure. The standard also sets: 1) LTD and loss-absorbing capital requirements applicable to covered IHCs (US intermediate BHCs with \$50bn or more in assets that are owned by foreign GSIBs); 2) “clean holding company” limitations on the operations of covered BHCs and IHCs; and 3) deductions

from regulatory capital of investments in the unsecured debt of covered BHCs applicable to all board-regulated banking organisations with total assets of \$1bn or more (see [here](#)). TLAC requirements are expected to phase in January 2019 and become fully effective in January 2022.

Criticism of these rules has focused on how the US implementation of liquidity and capital requirement rules put **domestic banks at a disadvantage relative to other banks**, European banks in particular. TLAC has the potential to have a significant impact on BHC capital structure, lines of business (further reducing capital allocated by covered BHCs to support market making activities), and financial returns (see [here](#)). Another concern seems to be the **pro-cyclicality of the standard**, which may force BHCs to increase capital ratios in a downturn and exacerbate the economic slowdown (see [here](#)).

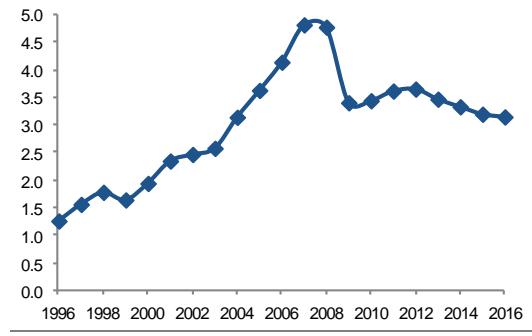
4. **SEFs** and the swap trading regime. The Dodd-Frank Act required a new regulatory framework for swaps trading, leading to the SEC and CFTC rules on swap execution facilities (SEFs) and swap trading on SEFs. The new regulatory framework drives reporting, clearing and settlement functions into SEFs (see [here](#)). The acting chair, Commissioner J. Giancarlo, has argued that **the current swap trading regulatory framework is unnecessarily inflexible and complex, and has resulted in a fragmentation of global financial markets, harmed market liquidity, and increased the systemic risk** that Dodd-Frank was predicated on reducing (see [here](#)). In his set of proposals for reworking the functioning of SEFs, he offers a roadmap for likely future changes to the current regulatory framework (more below).
5. The DOL **fiduciary rule** requires financial professionals that work with retirement plans or provide retirement planning advice to act legally and ethically as fiduciaries, acting in the client's best interest and putting those interests above their own (an upgrade from the suitability standard). **Critics of the rule have argued that it is onerous, both through higher compliance costs and loss of revenue from commissions** (with fears that the conflict-of-interest yardstick will essentially eliminate commissions).

Implications for US rates

Seven reporting metrics: risk and position limits and usage, risk factor sensitivities, value at risk and stress value at risk, comprehensive profit and loss attribution, inventory turnover, inventory aging, and customer-facing trade ratio – see [here](#).

The criticisms described above point to some of the potential changes in the regulatory framework, and possible implications for US rates. On the **Volcker Rule**, a way to address the general decline in liquidity conditions created by the current framework would be to create additional flexibility in how the metrics (see box on left) are used to establish limits on market-making inventory, hedges, financial exposures, and holding periods in the context of the reasonably expected near-term demand (RENTD) from clients (see [here](#)). This is the domain of the regulatory agencies (FRB, OCC, FDIC, SEC and CFTC - see [here](#)), and would not require congressional or presidential approval for changes. The driver of these changes may be endogenous (after all, the FRB staff has debated the effect of the Volcker Rule on liquidity – see [here](#)) but may also come about from exogenous political pressure (the heads of all the regulatory

Graph 2. Total financial assets of securities brokers and dealers



Source: SG Cross Asset Research/Rates, Board of Governors of the Federal Reserve, Financial Accounts of the United States

agencies are political appointees). **Graph 2** shows the recent evolution of brokers' and dealers' balance sheet size, which reveals a significant contraction post-crisis. Additional **flexibility in market-making limits is expected to lead to dealers committing more balance sheet to market-making activities**. This would likely **decrease balance sheet lending costs**, which is particularly relevant around crunch periods for liquidity, like quarter- or year-ends, and improve liquidity conditions in less liquid corners of the market, such as off-the-run issues, while likely improving profitability for dealers. Also, balance sheet constraints have been one of the drives for spread tightening over the past couple of years (see [here](#)), and **an environment where dealers are able to operate with larger balance sheets should support spread wideners**.

Regarding **CCAR** and **DFAST**, the president would need Congress to change the more substantive portions of the rule (see [here](#)). On the burden that the current regulatory framework poses on smaller community banks, however, FRB Chair Yellen has noted (see [here](#)) that "with the Congress's support, we have also taken action to relieve small holding companies of certain requirements". We expect this process to continue with a Republican-controlled House and Senate, and the president's push towards a more growth-friendly agenda. On the other hand, the criticism around the seemingly arbitrary nature of some of the qualitative aspects of the assessments is directed to the regulatory agencies. There seem to be good arguments for some subjectivity, as this likely helps prevent an arbitraging of the regulatory framework by financial institutions. Reaching the right balance between the regulators' objectives and the administration's goals may tilt the needle slightly towards less subjectivity, which would help reduce uncertainty in capital allocation and likely improve profitability. The direct implications for rates are more difficult to gauge in this case, although **an environment of increased lending, growth and employment (on which the regulatory easing effort seems to be predicated) is generally structurally bearish for rates**. Finally, on the "too big to fail" risk, CCAR and DFAST helped reduce the moral hazard associated with "too big to fail" institutions (by reducing the likelihood of the need for bailouts), but did little to address the issue of the actual size (and institutional risk) of some of the financial institutions, despite the tiering of the regulatory framework described earlier. In fact, the higher costs associated with the post-crisis enhancement of the regulatory framework may have led to higher levels of concentration in the financial industry. Our expectation is that issue will likely be addressed only insofar as any regulatory changes are expected to help reduced the burden on smaller institutions.

Objectives of the recent European Commission proposed amendments (see [here](#)) to the Capital

Requirement Directive and Regulation (CRR/CRD-IV), include "easing the burden for smaller and non-complex banks without compromising their stability" and "making it easier for banks to lend to SMEs and fund infrastructure projects and thereby to support investments", while noting that "capital requirements beyond a certain threshold may in the short term create unintended consequences, limiting banks lending capacity"

On **liquidity and capital requirements** for financial institutions (LCR, NSFR and TLAC), we note that the momentum in the recent European Commission-proposed amendments (see box on left) to the Capital Requirement Directive and Regulation (CRR/CRD-IV) seems to be in the direction of balancing the costs and benefits of the current liquidity and capital requirements, and tweaking the framework accordingly. For leverage ratios, for example, this could mean allowing for the calculation of derivatives exposure via SA-CCR (standardised approach for measuring counterparty credit risk), or, in order not to disincentivise client clearing by institutions, allowing the reduction of the exposure measure by the initial margin received from clients for derivatives cleared through qualified central counterparties (QCCPs). It may also mean being less punitive in the treatment of repo and derivatives. Given the perception that the US implementation of liquidity and capital requirement rules put domestic banks at a disadvantage relative to European banks, our expectation is that we may see action on this front in the US as well, particularly for the NSFR and TLAC portions of the regulatory framework, which are still to be fully implemented. Notably, a major provision of the CHOICE Act, just re-introduced by House of Representatives Financial Services Committee, is to exempt financial institutions from Basel III (see [here](#)), albeit under quite punitive capital standards (10% according to the legislature measure).

On TLAC in particular, some of the main topics of discussion are:

- a. The deductions from regulatory capital of investments in the unsecured debt of covered BHCs, which is applicable to all board-regulated banking organisations with total assets of \$1bn or more. Possible changes include (see [here](#)) pushing back the start of capital deductions towards 2022 to allow for the maturing of a significant portion of senior covered BHC debt issues in the hands of smaller institutions.
- b. The large overhang from additional debt issuance needed to meet TLAC and LTD requirements, and the impact from this overhang on the senior unsecured debt market. This could be addressed by changing definitions of eligible LTD, potentially grandfathering existing LTD (see [here](#)).
- c. The expected decrease in capital committed to certain market-making activities that produce low returns in order to meet profitability and financial return targets in a context of higher capital requirements, reducing liquidity significantly in some sectors of the market. Possible solutions to mitigate the liquidity woes in some of these segments may include electronic trading platforms or the application of block chain technology that releases capital by shortening the holding periods on positions (see [here](#)).

In terms of impact on US rates, we would expect any regulatory changes to generally be reflected in **higher levels of liquidity, by reducing financial institutions' HQLA needs, decreasing the significance of liquidity events around quarter- or year-ends, and the demand for RRP, which would ease some of the widening pressure in money market spreads**. Also, as we noted above, a major driver of any changes to the current regulatory framework is likely to be an **increase in banks' capacity to lend, with positive implications for growth and employment, and generally structurally bearish for bonds**. The most direct implication of TLAC and LTD requirements for the rates space has to do with the level of issuance needed to fulfil these requirements at the lowest possible cost. **A pick-up in issuance creates tightening pressure on the spread curve, particularly in the belly and back end**. However, under the proposed rules, no debt instruments with residual maturity of less than one year can count towards these ratios (debt with remaining maturity between one and two years still qualifies, but at a 50% haircut – see [here](#)). This has **pushed US banks into issuing senior debt with call options one year before maturity**, allowing them to call the debt before it stops counting towards their TLAC requirement, and therefore saving on interest payments for debt with no regulatory benefit. This **pick-up in callable structures may create some pressure on the volatility grid**, particularly in intermediate and long expiries on the left side of the grid.

Commissioner Giancarlo has proposed a regulatory framework for swaps trading based around five major principles (see [here](#)): 1) comprehensiveness; 2) cohesiveness; 3) flexibility; 4) raising standards of professionalism; and 5) an appropriate level of transparency, as he argues that excessive transparency can harm liquidity.

SEFs are likely the part of the regulatory framework where there is a more concrete vision for regulatory easing efforts. Commissioner Giancarlo has **proposed a regulatory framework for swaps trading based around five major principles** (see box on left), of which the two that involve a more significant level of regulatory easing are:

- a) **Cohesiveness**, with the proposal for removal of the distinction between required and permitted transactions (subject or not subject to the trade execution requirement, respectively) and the different execution methods (decreasing fragmentation in swaps trading and increasing the flexibility in execution methods), and eliminating the requirement for block trades to occur away from the SEF.
- b) **Flexibility**, with an emphasis (beyond the trade execution flexibility described above) on: 1) changing the current made available for trade (**MAT**) process (the Dodd-Frank Act generally requires that swaps subject to the clearing mandate must also be executed on a SEF, unless no SEF “makes the swap available to trade”) and allow for the development of

new swap products that meet market participants' needs; 2) moving away from the "all-to-all" market structure and towards a structure that reflects the nature of the swaps trading market and the different segments that exist; and 3) accommodating (beneficial) established swap market practices, allowing for third-party service providers (such as trade data vendors), and the use of services such as compression and risk-reduction services.

Overall, these recommendations create a more user-friendly platform for market participants, with increased liquidity, global access and flexibility. They may also further reduce the cost of trading in swaps, although there has been a significant reduction in bid/offer spreads for interest rate swaps over the past 12-18 months (roughly 25% by some estimates) driven in a significant part by the SEFs and clearing (the pick-up in algorithmic trading has been another factor in this compression). It is important to note, however, that as the liquidity on the screens increased, the liquidity in the inter-dealer market decreased, significantly reducing dealers' ability to hedge.

Finally, on the **fiduciary rule**, a downgrade to the suitability standard would likely create opportunities in some illiquid products that would otherwise be a difficult sell under the current regulation (given the level of compliance requirements associated with these products). One example of such products is variable annuities (VA). The product has seen some decline in marketing and sales over the past few years, as the global low-yield environment made them less attractive for insurance companies, but the prospect of an upgrade to the fiduciary rule also contributed to the recent decline. The downgrade to the suitability standard and the expectations for some normalisation of yields should support some resurgence of this product. Also here, the implications of this downgrade on the rates space are difficult to measure. In our VA example, the guarantees generally included in the product make insurance companies essentially short a long-dated equity put. VA portfolios hedge their exposure in the equity space through variance swaps or puts on the S&P, and in the rates space by being better payers (in the belly and back end of the curve) on a sell-off to hedge their rho exposure (receivers on a rally). The hedging of VAs adds to the impact of mortgage servicers in reinforcing the bear-widening/bull-tightening dynamic of swap spreads, and may be significant in a context of normalisation of yields ahead. More generally, however, the downgrade of the fiduciary rule should support profitability for financial companies, with all the positive implications this brings to the broader market (supporting lending, job creation and growth).

Conclusions

There are different levels of complexity in reworking some of the portions of the regulatory framework discussed above. In some cases, the president has the authority to enact changes (the fiduciary rule, for example), while on the other side of the spectrum, Trump will need Congress to change the rules (likely the case for more substantive changes to CCAR and DFAST). In a large number of cases, a significant level of regulatory easing is at the discretion of the regulators (in the Volcker Rule, for example, by adding additional flexibility in how the metrics are used to define risk and position limits and/or the definition of RENTD, or the tweaking the liquidity and capital requirements framework to achieve a better balance costs and benefits). On this latter point, it is important to note that the heads of all the regulatory agencies are political appointees, which naturally exposes these agencies to some level of political pressure. However, regulators are likely keen to preserve a sense of independence, and this is particularly true for the Federal Reserve. Please see ([here](#)) for a detailed analysis of the political process and economic implications.

At the Fed, the resignation of Governor Daniel Tarullo adds to the two open spots at the FRB, giving the president the opportunity to appoint three members. More significant, Governor Tarullo had been the point person at the Fed for financial regulatory issues, although he was never confirmed as Vice Chairman for Supervision (see [here](#)). His departure also adds to the resignation of Fed General Counsel Scott Alvarez, a key participant in the implementation of the requirements of Dodd-Frank (see [here](#)). **We are therefore in a process of significant changes at the Fed, which may leave it more open to the idea of some right-sizing of the regulatory framework.**

On this topic, however, Chair Yellen made her views rather clear during her recent testimony before Congress. Yellen noted how she agrees that the core principles enunciated in the president's executive order (see above) are very important goals, and she looks forward to engaging in this regulatory review. However, when asked about remarks on how banks are not lending (a reference to the president's remarks on how banks are not lending largely because of the burden of regulation that he intends to cut), the Fed chair also noted that "a recent survey by the national federation of independent businesses indicated that only 4% of respondents were unable to get all of the loans they needed", and "the fraction of businesses that quoted inadequate access to credit as their main problem stood at 2%".

On the broad implications for the rates space from regulatory easing of the different portions of the current regulatory framework we considered here, we note a few themes:

- a) The likelihood of an **increase in liquidity conditions** as capital allocated to market-making operations increases. This is significant not only around quarter- and year-end (with a likely decreases in the significance of liquidity events, and less widening pressure in money market spreads around these), but also more generally in less liquid corners of the market, like off-the-run issues.
- b) A bias towards **further tightening in bid/offer spreads** for swaps.
- c) Generally **structurally bearish implications for rates**, adding to the momentum provided by an improved outlook for growth and employment.
- d) While increased levels of corporate issuance to meet TLAC and LTD requirements may be slightly bearish for spreads, structurally **an environment where dealers are allowed to operate with larger balance sheets should support spread wideners**. This may be **compounded in a context of higher rates by a pick-up of convexity and VA hedging needs**, likely expressed in the belly or back end of the curve.
- e) A bias towards **downward pressure for intermediate and long expiries on the left side of the volatility grid**.

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