Liquidity in the bond & credit markets *– an update on capital and liquidity requirements*

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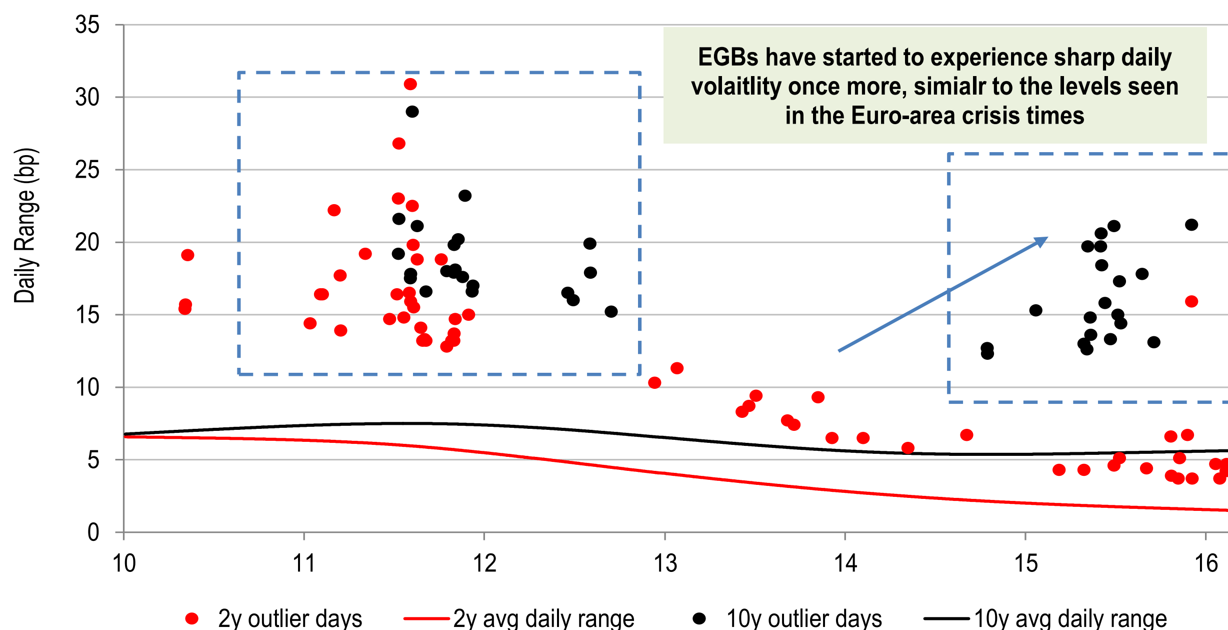
Recent trends in market liquidity: different assessments

- Recent trends in market liquidity : different assessments and focuses
  - The CGFS and some market regulators seem to consider that there is no real strain on market liquidity but consider the fundamental changes in the market structure (“what is the new normal?” “What is the transition path to the new normal?”)…
  - … while markets participants note
    - high levels of volatility
    - temporary market shutdown (e.g. Portugese Sovereign Debt in February 2016),
    - investors feedbacks on execution risk/ period of time necessary to execute large transactions,
    - Corporates feedbacks on the difficulty to find prices for long term swaps and cross currency swaps.



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Prudential rules : what's next?

While several tens of thousands pages of rules, technical standards, guidelines, recommendations, FAQs have been published by the Basel Committee, the FSB, IOSCO, the European Commission, the ESAs, the ECB/SSM and NCAs, a few rules will come into force later this year:

- Central clearing is starting in June 2016
- Initial Margins are starting in September 2016

This means that even if banks adapt to the new regulations before the start date (gliding path to reach targets on RWAs, leverage exposure, LCR and NSFR), the market impact of the new rules notably on the collateral needed will only be seen when bank and financial counterparties in scope start clearing and exchanging initial margins.

Banks hear converging views that they are properly capitalised and that subsequent regulatory modifications should not lead to significant additional capital; ***however,***

- **FRTB** is, according to the Basel Committee, expected to increase on average by 40% the trading book RWAs; ISDA, QIS4 refresh found that, should all desks receive IMA approval (which is very unlikely), the charge is more likely to result in a 50% increase, while should all desks failed their qualification test (which is also unlikely), the charge would increase by 240%.
- Basel is expected to publish the final specification and calibration for the **leverage ratio,** above 3% for the G-SIB
- The reference to SA-CCR in the leverage ratio would be welcome but creates unwanted effects notably by penalising end users transactions
- The cost of issuing **TLAC** (differential between holdco and opco senior debt) ranges from 30 bp to 130bp + the increase in cost of funding will depend on the final TLAC (and MREL) calibration
- The EC is expected to table a proposal in November that would cover the **FRTB**, **SA-CCR**, the **NSFR**, the **LR** in the CRR and the **TLAC** in BRRD.
- The EBA is considering to issue guidelines that would require banks to capitalise “excessive **CVA risk**” on derivatives transactions that are currently exempted (i.e. with corporates, pension funds and Sovereigns), while Basel considers removing the IMA approach
- On going work on internal models and **floors** are likely to increase the RWAs and required capital.
- The recent release (BCBS 362) on **Reducing variation in credit risk-weighted assets** raises a lot of issues, with a near complete reversion to the 1988 Basel I Accord for a number of important exposure classes (large corporates, banks, insurance companies, asset managers and specialised lending such as project finance).
- “Basel 4” (on going works on operational risk and IRRBB) would lead to a RWA increase of c. +15%-+25%.
- On going work is taking place in Basel and in Europe on the regulatory treatment of the **Sovereign exposures,**

➡ **Whereas the overall capital levels and long term funding might increase only slightly (??), banks expect at minimum some recalibration among risk factors. It is worth noting that all on going works and future regulations will drive trading activities capital requirements and costs higher.**

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Impact of the evolution of prudential rules on a primary dealer stylised portfolio (1/2)

The stylised portfolio was built two years ago; it is made of 13 bn long and 10 bn short of 10 year European Sovereign debts and 15 year Supra European issuers together with a small portfolio of derivatives (IRS and Cross currency swaps), a repo matched book (o/w 2 bn are deposited with the central banks, 10bn are lent for less than 6 months, 8 bn short are borrowed for less than 6 months). The market maker inventories were lent for less than 6 months.

The traded risk teams computed the risk based capital requirements (without any impact of the Prudent valuation capital requirements but based on full implementation of CRD4). We have also computed below the leverage ratio capital requirement (based on the definition at that time) and, on the basis of a decreasing over time COE, increasing CIR and stable Taxes, the required PnL.

Between the end of 2011 (after the Sovereign crisis and after the introduction of the Stress VaR) and mid 2015, capital requirements on the Euro Rates activity (the primary dealer on Euro Sovereign debt) have been multiplied by more than 3, our inventories (sum of long positions) in the European Sovereign debts in euro have been divided by c. 2 during the same period, while our position in the league tables (#3) and our market share (7% on average) remained stable.

Year	Type of portfolio	Capital driven by risks (€m)	Capital driven by a 3% leverage (€m)	Capital driven by a 4% leverage (€m)	Max capital	ROE	Tax	CIR	PnL (€m) - pre bank structure-
2010	Bond	132			132	14%	25%	50%	49
2010	Derivatives	10			10	14%	25%	50%	4
2010	**total portfolio**	**142**			**142**	**14%**	25%	50%	**53**
2011	Bond	324			324	12%	25%	55%	115
2011	Derivatives	10			10	12%	25%	55%	4
2011	**total portfolio**	**334**			**334**	**12%**	25%	55%	**119**
2014	Bond	590	930	1240	930	9,5%	25%	60%	295
2014	Derivatives	147	40	53	147	9,5%	25%	60%	47
2014	Central bk depo		60	80	60	9,5%	25%	60%	19
2014	**total portfolio**	**737**	**1 030**	**1 373**	**1 077**	**9,5%**	25%	60%	**360**

The level of capital allocated to each business line not being elastic, there was a strong pressure on banks to reduce their exposures and risks. This is likely to fuel a circle whereby lower access to balance sheet equaling lower resilient liquidity increases volatility, which in turn increases the VaR and Stress VaR, i.e. risk capital, which requires further reduction of inventories… It is also likely that the financial communication of banks on their initiatives to reduce the RWAs of trading assets increase the pressure on boards and executive managements to reach a strategic model that not only serves adequately the clients but also delivers more stable revenues together with more predictable capital (hence the need for certainty on capital requirements and the finalization of the Basel 3 framework).

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Impact of the evolution of prudential rules on a primary dealer stylised portfolio (2/2)

Year	Type of portfolio	Capital driven by risks (€m)	Capital driven by a 3% leverage (€m)	Capital driven by a 4% leverage (€m)	Max capital	ROE	Tax	CIR	PnL (€m) - pre bank structure-	
2010	Bond	132			132	14%	25%	50%	49	
2010	Derivatives	10			10	14%	25%	50%	4	
2010	total portfolio	142			142	14%	25%	50%	53	
2011	Bond	324			324	12%	25%	55%	115	introduction of stress VaR in 2011
2011	Derivatives	10			10	12%	25%	55%	4	
2011	total portfolio	335			335	12%	25%	55%	119	
2014	Bond	590	930	1240	930	9,5%	25%	60%	295	introduction of IRC and LR in 2014
2014	Derivatives	147	40	53	147	9,5%	25%	60%	47	
2014	Central bk depo		60	80	60	9,5%	25%	60%	19	shows the impact of central banks deposits in the L exposure
2014	total portfolio	738	1030	1373	1137	9,5%	25%	60%	360	
2016	Bond	590		1240	1240	9,5%	25%	60%	393	With a bank LR target at 4%
2016	Derivatives	147		95	147	9,5%	25%	60%	47	Shows the impact of the new LR method (one way clients are penalised)
2016	Central bk depo			80	80	9,5%	25%	60%	25	
2016	total portfolio	738		1415	1467	9,5%	25%	60%	465	
2018	total portfolio	1328		1415	1415	9,5%	25%	60%	448	show the potential impact of FRTB (best case)
2018	total portfolio	1624		1415	1624	9,5%	25%	60%	514	worse case

Year	LCR (m)	Funding rate	cost of ST funding (m)	NSFR on portfolio (m)	Funding rate	Cost of LT funding (m)	PnL (m)	
2014	3500	0,2%	-7,0	8450	0,30%	-25,4	-32,4	
2017	3500	0,20%	-7,0	8450	0,44%	-37,2	-44,2	Show the impact of TLAC on cost of funding

nb / funding costs of derivatives are not fully "new" to the main banks, but LCR and the fact that the NSFR is asymetric (with regard to the IM received) +20% on payables are new additional costs.

Year	Capital (€m)	NSFR+LCR	PnL
2010	142		53
2011	335		119
2014	1137	32	392
2016	1467	32	497
2018	1520	44	525

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