BRAVE NEW WORLD

Ian Tyler charts the changing nature of banks as they evolve under successive rounds of regulation and sets out the impact on treasurers

With a delicious sense of irony, change is one of the few constants in life. As the dramatic events of 2016 have revealed, even the most established of global norms are subject to change, fuelled by the relentless march of technology and the ongoing impact of the economic crash.

One of the main responses of the authorities to the crash was a complete overhaul of bank regulation both in content and in style. Banks today hold almost an order of magnitude more equity capital than they did in the summer of 2007.

They have also been subject to large fines for historic misconduct and are now subject to far greater regulatory oversight, increased reporting requirements and increased personal liability for senior management.

Consequently, fewer bright graduates now put a career in finance at the top of their 'employer of choice' list compared with pre-2007/8. Google is now more prestigious than Goldman.

But, despite significant shifts, some aspects of regulatory changes have yet to be realised. While the pace of new regulatory initiatives is now slowing, the significant time taken to implement many of these means that much of the impact on bank behaviour (and, ultimately, the end customer) has still to manifest.

Over the next few years, the full force of these changes will be felt, as several key pieces of legislation come into effect.

MiFID 2

The first initiative to have an impact on European banks comes into force on 3 January 2018.

Known as the Markets in Financial Instruments Directive II (MiFID II), and the accompanying Regulation (MiFIR), its main objective is an increase in investor protection.

For corporate treasurers, the most immediate consequence of this will be the greater transparency provided by banks on pre- and post-trade execution. Less important will be the creation of new regulated trading platforms (organised trading facility) to capture more activity that is traded on unregulated platforms.

But, as investment firms continue to analyse the implications of regulation on their business models, strategic decisions will need to be made. Some of the lower-tier investment firms are likely to continue to reduce their service offering as the limited sales volumes for certain products no longer justify the increased compliance cost.

It is likely that one of the unforeseen consequences of this new legislation will actually be a greater concentration of activity in the very largest trading banks.

This may have implications for which bank counterparties are available for a particular financial instrument – something for corporate treasurers to monitor.

IFRS 9

Just two days earlier, IFRS 9 comes into effect within Europe.

While IFRS 9 covers a number of areas, it is the new standard for loan provisioning that will have the biggest impact on banks and may impact their future appetite for certain types of credit.

Compared with existing loan provisioning, IFRS 9 is forward-looking in nature and brings in the concept of expected credit loss. The day a loan is originated, the bank will now have to book a loan provision for one year's expected credit loss.

Given that the loan will earn income on an accrual-accounted basis, the bank is, in effect, booking a loss on day one. If there is any subsequent significant credit deterioration for that loan, then the provisioning moves to stage two and is converted to a lifetime of expected credit loss.

To forecast provisions, a macroeconomic forecast is required – one that the new legislation insists should be unbiased and probability weighted. But, given the imprecise nature of economic forecasting, we can expect, without any inherent bias, that a selection of banks will have a distribution for their central forecasts for the economies in which banks operate.

There is clearly a range of reasonable values for such important economic numbers as unemployment or GDP. When including the potential for subtle (or unsubtle) forms of bias to manifest in the economic forecasting process, then the dispersion of economic forecasts will increase further.

For many banks, it will be the combination of IFRS 9 and stress testing that effectively becomes their binding capital constraint. Banks will look to manage this constraint, and one of the most obvious ways to do so, is to reduce the term commitment of loans.

RING-FENCING

Looking ahead to January 2019, major UK banks are meant to have implemented ring-fencing. This will mean their core retail banking activities will have to be in a ring-fenced bank (RFB) and certain excluded activities, such as trading of derivatives, must be in a non-ring-fenced bank (NRFB).

For treasurers, the main impact that they will need to consider is that the new NRFBs are likely to have a lower credit rating than the current bank. This will mean that they need to look at their counterparty credit risk policies, including their attitude to giving and receiving collateral.

What will be particularly interesting is whether the rating agencies give the respective NRFBs, as well as the RFBs, some credit for the large volumes of structurally subordinated bail-inable senior debt that is now being issued out of the banks' holding companies to meet the forthcoming total loss-absorbing capacity/minimum requirement for own funds and eligible liabilities requirements.

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While probability of default might be higher for an NRFB than its sister RFB, the loss given default may actually be lower, as insured retail deposits in the RFB are now structurally senior to other senior exposures.

A banking group can still approve one overall credit limit for a corporate counterparty and then allocate that limit within the group across the various RFBs and NRFBs. One overall relationship manager is still allowed in theory, but there will be some constraints on what they can and cannot do.

For the banks that have chosen to put much of their corporate activity in the RFB, one other aspect that the regulators will monitor closely is whether the RFB is in effect subsidising the NRFB's selling of ancillary services by the provision of 'cheap' revolving credit facilities.

BASEL IV

Formally, there is no such thing as Basel IV, as regulators insist that the various proposals are just further enhancements to Basel III, but it remains a useful shorthand for proposals still coming down the pipeline.

The main proposals relate to change to the use of Advanced Internal Ratings Based (A-IRB) credit models, the fundamental problem with which is that implementation has not been consistent across jurisdictions. The same credit can receive very different risk weightings.

The Department for Business, Innovation and Skills (BIS) has proposed four solutions to reduce this variability:

1) Remove the option to use the IRB approach for certain exposures;
2) Impose new model parameter floors to ensure minimum level of conservatism;
3) Provide greater specification of estimation parameters; and
4) Implement an output floor against Standardised.

SHUTTERSTOCK

The current proposals would mean that the largest corporates (with total assets exceeding €50bn) would be forcibly moved out of A-IRB and onto Standardised.

For corporates with asset bases below €50bn, there is a split between those with a revenue of above €200m per annum and those with a revenue below. Those below can stay on A-IRB, whereas those above would be forced onto foundation IRB.

This would mean that the largest corporate risk-weighted assets weighting would revert to 100%, which is actually higher than the 75% standardised weight used for claims on small business – hardly risk sensitive. It will certainly reduce banks' return on regulatory equity for large corporate exposures, so may in turn reduce banks' appetite to hold significant exposures to such firms.

Perhaps, unsurprisingly, the jurisdictions that have implemented the A-IRB models with the lowest weightings are the least keen on BIS's proposals and, at present, their opposition is delaying finalisation of their approval. Watch this space to see how these play out over time.

THE ROAD AHEAD

On a stand-alone basis, many of the changes coming into effect are sensible – and banks have undoubtedly had enough time to prepare for them.

What remains to be seen is how the combined effect on bank behaviour will play out. The rational response of both providers of capital and customers may be to migrate additional financial services activity out of the banking sector. It looks like the shadow-banking sector is set to grow further.

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