Minutes of the June 06 2014 Financial Advisory Roundtable (FAR) Meeting


The overall topic of the meeting was the evolution of the financial sector in the new regulatory environment. The meeting commenced with presentations from roundtable members centered on the questions posed in the meeting agenda (http://www.newyorkfed.org/aboutthefed/far.html). Each set of remarks was followed by an open discussion. These presentations were followed by an open discussion among FAR members. The main topics were as follows:

How have changes in accounting standards affected the financial sector? Some FAR members argued that the FAS 166 and FAS 167 standards related to off-balance-sheet accounting have had a smaller impact on securitization than originally expected, given that new securitizations still generally qualify for sale / off-balance-sheet accounting treatment. These accounting standards have however resulted in increased public disclosure of securitization activity. Members also discussed implications of FAS 166/167 for the design of repurchase agreements as well as money market mutual funds and asset-backed commercial paper conduits. Members noted that off-balance-sheet accounting has implications for banking firms’ regulatory capital adequacy via the leverage ratio. Members also discussed the implications of accounting standards updates (ASUs) regarding the recognition and measurement of financial assets and liabilities. Some FAR members argued that regulatory capital requirements should be based on fair value accounting.

How has the new environment affected trading activity? FAR members highlighted the fact that trading volumes and income have declined in recent years, particularly for fixed income securities, currencies and commodities. Members attributed this decline in part to regulation, and in part to other factors such as changes in perceptions of risk. Some members also argued that banks are still in the process of adjusting to changes in the trading environment, and that further adaption is likely to involve some firms choosing to exit lines of business where trading volumes have declined. Participants noted however that a trading presence has synergies with other activities within a bank, such as the treasury function and debt and equity capital markets. While the Volcker rule has led banks to close their proprietary trading desks, several FAR members suggested that the additional structural impact of the rule on trading activity is likely to be relatively limited, although compliance with the rule will involve costs.

Has the new regulatory environment caused activity to shift outside the US banking system? There was discussion that new regulations and capital requirements have and/or will increase the cost of capital for US banking firms. It was noted that non US banks subject to
the Enhanced Prudential Standards issued by the Federal Reserve will be operating on similar rules for activities undertaken in the US. Tight regulation, while reducing risk for regulated firms, may cause a shift in market activity into less regulated parts of the financial system. FAR members cited cases of shifts in asset holdings and activity to nonbanks, particularly in areas where the economic cost of capital is below the regulatory cost. For example, some members cited a shift in bond inventories and repurchase agreement activity from broker-dealers to mutual funds, exchange traded funds (ETFs) and real estate investment trusts (REITs). FAR members also noted that over-the-counter interest rate derivatives trading volumes had increased in the UK relative to the US. Differences in termination rights were suggested as a possible explanation for this trend.

**How are banks responding to higher and multiple capital requirements?** FAR members discussed how the joint presence of higher risk-based capital requirements and a higher leverage ratio would affect bank behavior, and which of these two types of capital requirements is more likely to be binding. Members suggested that the leverage ratio is harder to manipulate and more robust to measurement error, but may distort behavior by giving firms incentives to take excessive risks. It was also noted that these capital requirements interact with other regulations, such as the comprehensive capital analysis and review (CCAR) and liquidity funding ratio (LCR). FAR members noted the difficulty of measuring the cost of capital and optimizing behavior in the presence of multiple regulatory capital requirements. In considering the competitive effects of higher US capital requirements, members highlighted both the costs of higher capital as well as the benefits in terms of greater bank safety. It was also highlighted that European banks have less experience with leverage requirements and therefore that their optimisation of business and balance sheet mix relative to multiple constraints may take time.

**What would be the effects of shifting from OTC markets to exchanges?** One of the recent developments in the new environment is the trend towards direct exchange and agency intermediation and away from over-the-counter (OTC) markets. Members argued that this, in turn, is contributing to disintermediation of broker dealers. FAR members highlighted the increasing prominence of hybrid OTC market approaches and the swap execution facilities, which act as mini exchanges. As a result of the move towards central clearing and the trade compression resulting from netting of trades, notional amounts may be an imperfect measure of market activity.

**How is the new environment affecting competition?** Within the banking industry, participants suggested that economies of scale associated with increased fixed compliance costs may lead to increased market concentration. As discussed above, banks face increased competition from nonbanks. Some members argued that public policy should encourage growth in trading platforms to increase liquidity and reduce reliance on broker-dealers.