Futures and Futurization: Full Steam Ahead on Dodd-Frank

November 19, 2012

During a November 14 Senate Banking Committee hearing on Basel III rules, a big focus was on the capital regulatory framework's impact on community banks. There is no doubt that both Democratic and Republican representatives, as well as bank regulators, want higher capital requirements for the large, internationally-active banks.

Dodd-Frank Act financial reform is pushing over-the-counter derivatives trading toward centralized clearing, meaning banks' quest for capital efficiency will continue to drive more derivatives transactions to clearing houses.

Since the big U.S. banks are the major players in the global derivatives market, their actions will have a significant impact on the way that the buy-side firms, insurance companies and commodities companies design their derivatives trading strategies.

CAPITAL REQUIREMENTS FOR BIG BANKS ARE HERE TO STAY

The November 14 Senate Banking Committee hearing, "Oversight of Basel III Impact of Proposed Capital Rules," sought clarification from bank regulators including the Federal Reserve, Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) on how Basel III is being developed and eventually implemented in the U.S.

Presenting prepared remarks and asking the most questions were Republicans Bob Corker and Richard Selby and Democrats Sherrod Brown and Tim Johnson. All of them in one way or another emphasized the importance of capital for the largest U.S. banks. If there was any doubt, banks will have to hold the Basel III recommended levels of capital to function as a cushion for unexpected losses arising from credit, market, operational, and liquidity risks.

Moreover, large banks will also have countercyclical and Significant Financial Institutions charges. Importantly, the quality of Tier I capital will have to be much higher so that it has more loss absorbency, unlike Basel II. While Shelby could hardly hide his dislike of Basel III and of financial regulators, this does not mean that he advocates less capital requirements for big internationally interconnected banks.

"The primary goal of Basel III is to strengthen bank capital requirements. This is a worthy goal as strong capital requirements are essential for a safe and sound banking system and to protect against taxpayer-funded bailouts. Unfortunately, one of the clear lessons of the financial crisis is that bank regulators set capital requirements too low."

Brown was even bolder and more specific. He criticized Basel II's Tier I for allowing instruments that did not have sufficient loss absorbency. Moreover, he was adamant that Basel III's new leverage rule does not go far enough despite the fact that it is not risk-weighted unlike the measurement for credit risk.

The U.S. benchmark of 4% of capital over total assets is also too low, Brown said, noting that Andy Haldane, the Bank of England's Executive Director for Financial Stability , estimated institutions would have needed a minimum 7% leverage to have survived the financial crisis. "My legislation, the SAFE Banking Act calls for 10% tangible equity to total assets, not adjusted for risk and including those held off-balance sheet," Brown said.

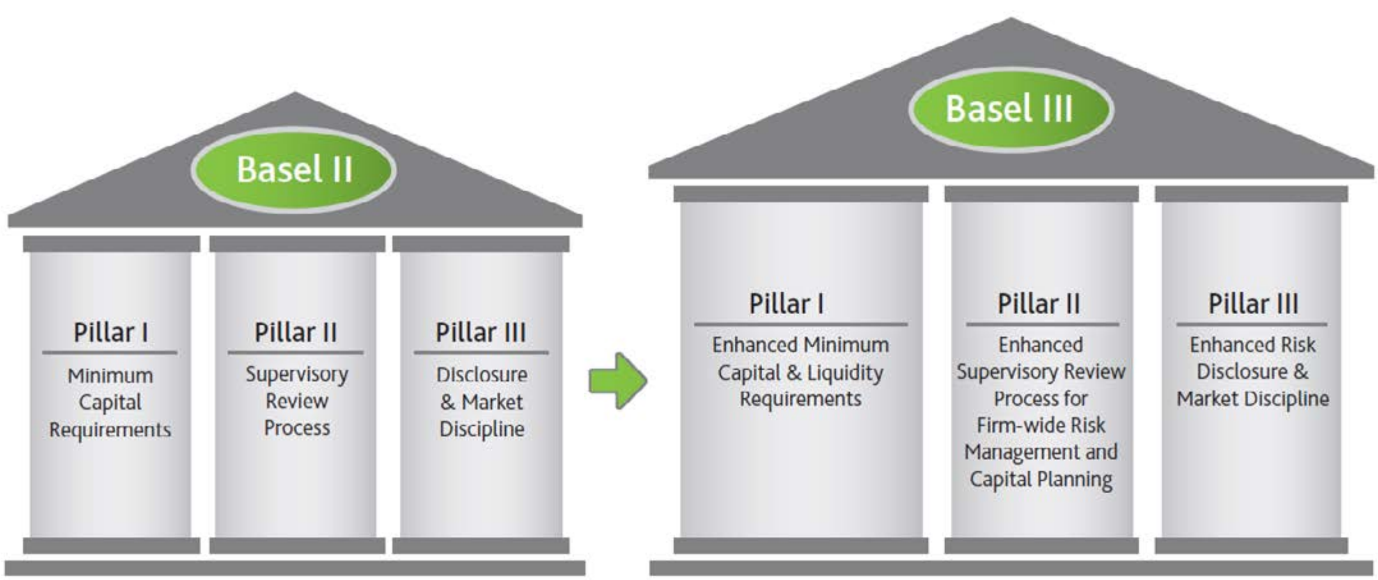
Certainly from the testimony of the Fed, the FDIC, and OCC, it is clear they felt Basel III is much better than Basel II and that big banks need to be well capitalized. In fact, the next day at the Clearing House's Second-Annual Business Meeting & Conference, Comptroller of the Currency Thomas Curry stated his support for Basel III and wanting to reduce regulatory uncertainty.

"I think we need to get the rules in place as quickly as possible," Curry told reporters after the speech, declining to be more specific about timing. "We need good rules, but we need to do this quickly. A lot of the uncertainty that we've seen is really due to not knowing the rules of the road."

- All "vanilla" OTC contracts should be traded on exchanges.
- Such contracts should be traded through central counterparties (CCPs).
- Such contracts should be reported to trade repositories.
- OTC contracts that are not cleared by a CCP should be subject to higher capital requirements.

BANKS: IN SEARCH OF CAPITAL EFFICIENCY

The origins of Dodd-Frank's requirements on financial and commodity derivatives lie in the 2009 G-20's Pittsburgh communiqué. Due to the 2008 financial crisis, G-20 countries set forth four core tenets for over-the-counter derivatives reform:



Basel III strengthens the three Basel II pillars, especially pillar 1 with enhanced minimum capital and liquidity requirements.

Source: "Basel III New Capital and Liquidity Standard-FAQ," Moody's Analytics, November 2012

Due to Dodd-Frank and recent developments with Basel III, implications for big banks in the U.S. could not be clearer: Basel III capital requirements are here to stay, and in fact, if the SAFE Banking Act were to pass, big banks may face even higher capital requirements.

Hence, banks will be focused on ways to reduce capital requirements. They can do that by transacting derivatives with CCPs. This summer, the Basel Committee on Banking Supervision just published guidance on risk weighting cleared derivatives and other guidance for clearing with a CCP. The requirements are a lot less onerous for banks than they had anticipated; hence, market participants can expect that banks will increase the speed at which they are gravitating to use CCPs.

Already in the last two months, CME Group, Eurex, Eris Exchange, Intercontinental Exchange (ICE), and NYSE Liffe have been publically commenting about increasing movement from banks to futures or futures-like products, something that would have been unimaginable a few years ago.

According to the OCC, in the second quarter of 2012 the top 25 U.S. banks had only about 4% of their derivatives contracts at exchanges. Given this low percentage, clearing houses and exchanges are looking at a big business opportunity as banks increasingly comply with Dodd-Frank.

Every exchange and clearing house will have to prove to its customers and to financial regulators that it has implemented sufficient safeguards to avoid becoming the next "too-big-to-fail." Market confidence will greatly influence their sustainability and success. Over the weekend, CME Group announced it is expanding its credit facility from $3 billion to $5 billion, with an ability to seek up to $7 billion. ICE has a $2.1 billion credit line.

TOP 10 US BANKS' ACTIVITIES IN EXCHANGE TRADED DERIVATIVES

Bank	Exchange Traded % of Total Derivatives Portfolio
JPMorgan	4.1
Citibank	2.7
Bank of America	3.6
Goldman Sachs	4.4
HSBC USA	4.1
Wells Fargo	7.6
Morgan Stanley	0.2
Bank of NY Mellon	2.7
State Street	0.6
PNC Bank	25.9

Source: OCC, Second Quarter 2012

Given the big U.S. banks are the major players in the global derivatives market, their pursuit of capital efficiency means that they will continue to transition from OTC derivatives transactions to cleared versions and also to futures or futures-like operations.

This means non-banks will still be able to transact OTC derivatives, but because these have higher capital implications for banks, since they have to account for the credit and operational risk thereof, they will have to pass on the cost to non-bank counterparties. Hence, non-banks globally will also be incentivized to use cleared derivatives, which are cheaper than OTC derivatives with banks.

Simultaneously, under Dodd-Frank, the Commodity Futures Trading Commission (CFTC) requires that having an annual derivatives portfolio of $8 billion makes you a swap dealer, pushing up reporting requirements. This will incentivize companies to trade more in futures or futures-like products.

CORPORATIONS: REACTING TO DODD-FRANK

Unlike banks, which are used to being regulated, supervised, and examined, most corporations of all sizes in the U.S. have been comparably slow to react to the fact that Dodd-Frank very much impacts anyone in the derivatives world.

The table below offers examples of the many business areas Dodd-Frank impacts in an energy company and much here is insightful and relevant for other corporations.

AREAS AFFECTED	POTENTIAL IMPLICATIONS
Energy derivatives	Strategy/business model; risk management
Business entity categorization: exempt vs. non-exempt	Strategy/business model; regulatory requirements reporting, process and controls; liquidity
Clearing and trading	Liquidity; risk management
Counterparty status	Liquidity; risk management
Non-cleared swaps reporting	Regulatory requirements, reporting, process and controls
Energy trading process and procedure development	Regulatory requirements, reporting, process and controls
Energy trading disclosure requirements	Regulatory requirements, reporting, process and controls
Government payment disclosure requirements	Regulatory requirements, reporting, process and controls
Trading exchange requirements, controls, and reporting	Regulatory requirements reporting, process and controls
Trading activity controls	Regulatory requirements reporting, process and controls
Trading tax liabilities	Liquidity

Source: Grant Thornton

If the reaction of energy companies is representative of other sectors, then corporations and their investors should be concerned. Based on a recent survey by Platts, the energy news and data service, businesses in that industry haven't spent much to get ready for Dodd-Frank.

According to Platts, over 25% of nearly 50 companies surveyed said they have budgeted nothing to comply with new reporting and record-keeping rules the CFTC plans to have in place early next year.

Many of the firms with no budget are energy producers and utilities, which believe they will be classified as end-users under the CFTC's derivatives regulatory regime and not subject to the costly rules swap dealers and major swap participants are expected to face, the survey found.

It is important for companies to realize that not only does Dodd-Frank require that they at the very least have some reporting and record-keeping requirements even if they are not a swap dealer, but also that Basel III will continue to influence big banks' focus on capital efficiency, and hence their derivatives trading strategies.

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[1] Andy Haldane, Executive Director for Financial Stability, Bank of England. Mr. Haldane caused quite a stir this summer with his remarks that there should be a rewrite of Basel III capital rules.

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