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# Evolving regulatory environment and the impact on investors

## How is the regulatory environment changing and what are the implications for investors?

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*"At the heart of banking is a suicidal strategy. Banks take money from the public or each other on call, skim it for their own reward and then lock the rest up in volatile, insecure and illiquid loans that at times they cannot redeem without public aid."*

***James Buchan***

*"…the most recent regulatory changes are designed to not only reduce the risk of bank failures, but more clearly apportion losses to the wholesale funders."*

At the very heart of banking is an inherent inconsistency, which means it is all but inevitable that at some stage public support will be necessary to ensure its uninterrupted operation. Despite attempts to achieve a greater degree of separation, the inability of the public sector to completely wash its hands of all responsibility for the banking system has been clear since the Emperor Tiberias in AD33 used the imperial treasury (100 million sesterces or around USD2bn in today's money) to stabilise the first recorded financial crisis in history.

The most recent episode of financial instability in 2008 once again brought home to regulators the inherent risks within the existing regulatory framework, especially with respect to large financial institutions, which were basically viewed as being 'too big' for governments to allow to fail. This provided a wake-up call after the more liberal regulatory and supervisory framework of the 2000s. The process of addressing the limitations of existing regulations has taken time, but the results have been a series of material changes in the regulatory framework applying to the major banks[1]. In turn, these regulatory changes will have implications for capital markets and, inevitably, investors. In the paper entitled 'Term Deposits: Have they had their day in the sun?', Russell Investments highlighted the impact of the Liquidity Coverage Ratio on investing

[1] While the term ADI refers to a wide range of financial institutions in Australia, for simplicity, Russell Investments will often simply refer to banks in this paper.

in TDs. The following brief paper outlines the other regulatory changes along with the potential implications for investors.

Acknowledging that the public sector cannot walk away from the banking system, the most recent regulatory changes are designed to not only reduce the risk of bank failures, but more clearly apportion losses to the wholesale funders of the banks, rather than the government having to bear the full cost of any support, i.e. governments/taxpayers will still have to incur costs to support banks, but those costs will be more evenly shared with the other providers of funding to banks. Such regulatory changes are consistent with the overall aim of managing, to the greatest extent possible, the contingent liability of governments to support major banks. Some of the more important regulatory changes are set out in Figure 1.

| REGULATORY CHANGE | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|
| **Liquidity coverage ratio** | Implemented Jan 2015 | | | | |
| Net stable funding ratio | | | | Implement Jan 2018 | |
| APS 120 (securitisation) | | | | Implement Jan 2018 | |
| Total loss absorption capacity | | | | | Implement Jan 2019 |
| Basel IV risk weightings | | | TBC | | |

## 'Basel IV' Capital Risk Weights (implementation date not yet formalised)

To put the more recent changes in the capital risk weightings in context, it is necessary to take a walk down memory lane. Such a walk serves the dual purpose of highlighting not only how regulations have evolved, but also how changes in regulations have occurred, as a result of limitations in the existing regulatory regimes being exposed by ongoing developments.

- Basel I in 1988 set out the minimum capital requirements of financial institutions with the goal of minimising credit risk. Importantly, Basel I established risk-based capital requirements as the fundamental precept of the global approach to regulation of banks.
- The initial framework had limitations, which lead to regulatory arbitrage and inadequate capital levels being held by banks. In response, in 2004, Basel II set out to ensure greater consistency of regulations globally to limit competitive inequality among banks operating across multiple regulatory jurisdictions.
- The Global Financial Crisis (GFC) in 2008 highlighted further inadequacies in the regulations. Basel III intended to strengthen bank capital requirements by increasing the level of liquidity banks were required to have, and decrease the allowable amount of leverage in banks. In addition to the risk weighted capital requirements of Basel II, Basel III also introduced an additional non-risk weighted minimum 'leverage ratio' requirement as a stop gap measure, until more standardised risk weightings could be introduced for the calculation of risk-based capital requirements.
- The more standardised risk weightings subsequently evolved as part of a series of requirements often referred to collectively as Basel IV. Basel IV comprises a new set of requirements intending to standardise aspects of risk management and monitoring. The new regulations aim to limit the use of internal processes for monitoring risk and level the playing field globally between banks.

  Importantly, compared to Basel II, Basel IV adopts a more granular approach to setting risk weights by type of loan and Loan to Value Ratio. The two areas most impacted are loans on real estate where the proposed changes in risk weightings are shown in Figure 2. For example, the risk weighting for an investor loan to finance property (referred to as a loan being dependent on the property for debt servicing) with a Loan to Value Ratio (LVR) of 60-80% rises from the current 35% to a significantly higher 90%.

**FIGURE 2: Basel IV Standardised property risk weights**

Residential Real Estate Risk-Weighted Assets (RWA) Debt Servicing Property Dependent

| LTV | NO | YES | CURRENT |
|---|---|---|---|
| 0-40% | 25% | 70% | 35% |
| 40-60% | 30% | 70% | 35% |
| 60-80% | 35% | 90% | 35% |
| 80-90% | 45% | 120% | 70% |
| 90-100% | 55% | 120% | 70% |
| >100% | C'party | 120% | 70% |

Commercial Real Estate RWA Debt Servicing Property Dependent

| LTV | NO | YES | CURRENT |
|---|---|---|---|
| 0-60% | 60% min | 80% | 100% |
| 60-80% | C'party | 100% | 100% |
| >80% | C'party | 100% | 100% |

### Implications for Investors

The changes in risk weightings, coupled with a greater focus by banks on maximising returns in a lower credit growth environment, will, over time, have an impact on bank lending priorities. More specifically, there will be a bias for banks, all else being equal, to reduce relative exposures to the higher risk weighted classes of loans due to the higher associated capital costs.

An implication of this bias will be that banks may begin to reduce the relative exposure to commercial and residential real estate, which is dependent upon property income to service debt. As banks reduce exposures to these areas, it is increasingly likely that borrowers will look to tap non-bank sources of finance directly. This will provide opportunities for investors to fill the funding gap via private debt. We would anticipate, that as a part of this ongoing process, there is likely to be an increase in the supply of less liquid private debt to non-bank investors. While new opportunities for investors may open-up, due caution must be applied, as the characteristics of such debt will be more idiosyncratic and, accordingly, may vary significantly from the more generic corporate debt readily traded in secondary markets.

## Total Loss Absorbing Capacity (TLAC) (target date Jan 2019, but likely to be delayed)

TLAC rules are designed to ensure that a greater proportion of the bank's liability structure can be explicitly 'bailed in' (i.e. converted to equity or written off) at the discretion of regulators. The intent is to ensure that shareholders and creditors shoulder more of the burden of any future recapitalisation and by extension reduce the level of contingent liabilities governments (i.e. taxpayers) face, with respect to providing future support to the banking system. The TLAC is applicable to Global Systemically Important Institutions with the Financial System Inquiry recommending that the requirements be extended to the major Australian banks.

### Implications for investors

While the application of this rule is yet to be fully defined, there has been a more immediate impact on the risks associated with bank hybrids, as regulators have moved well ahead of the formalisation of the new regulatory regime.

One of the key characteristics of hybrids is that they are counted as bank capital, since it is expected by the regulator that, under certain circumstances, the issuing banks would convert such securities into equity. The events of 2008 highlighted how, in

practice, banks are very reluctant to undertake such conversions unless they have run out of all other alternatives, **including government support**. The result has been a change in the treatment of hybrids so that, while the issuer can still effect conversion, the ability to trigger conversion also rests with the regulator if the bank is deemed to be at risk of becoming 'non-viable'.

It is worth highlighting that there is a distinction between a bank going under/failing and what is termed as a 'non-viability trigger' by the regulator. Most investors understand what a bank failure is and, in Australia, most investors expect that the risk of this occurring for major Australian banks is very low.

'Non-viability,' however, is a more nebulous concept. Specifically, the regulator deems a non-viability trigger as being when APRA believes, "A public sector injection of capital, or equivalent support, is necessary because, without it, XXX would become non-viable". Under such a definition, 'non-viability' could be triggered by a temporary inability to access liquidity/capital or funding markets freezing up due to a removal of confidence, i.e. non-viability could be triggered by a temporary liquidity event, not just an insolvency event. Accordingly, in some respects, the risks associated with hybrids have potentially increased.[2]

## APS120 Securitisation (effective January 2018)

This regulation establishes practices to manage the risks associated with securitisation and to ensure sufficient regulatory capital is held against the associated credit risk. There are several elements to the proposals, which become quite complex. In essence, the regulations require that in order for the issuing bank to receive full capital relief, the security holders should have limited recourse to the issuing bank.

### Implications for investors

For investors, there will be a range of implications. Some of these are positive and others potentially negative. A couple of the key implications are:

On the positive side, the new regulations facilitate 'master trust' structures, which allow banks to issue mortgage backed bonds with a 'bullet' or defined maturity, rather than forcing investors to wait for the funds to trickle in as home owners pay down their loans; i.e. amortising. The positive aspect of this is that it will increase the attraction of the market to new classes of investors, e.g. offshore investors.

On a negative note, the ability of issuing banks to provide support to the structure via holding subordinated tranches, i.e. tied in or aligned to the 'special purpose vehicle', will be curtailed if they wish to receive capital relief. This has implications for investors who viewed that:

(a) co-investment by banks provided the key source of confidence in the quality of the security; and

(b) banks would inevitably have to stand by such securities.

Post the introduction of APS120, investors may need to be more diligent when considering and analysing such securities, as the interests of the investor and issuing bank may be less clearly aligned.

## Net Stable Funding Ratio (NSFR) (effective from January 2018)

The NSFR is a quantitative global liquidity standard established by the Basel Committee on Banking Supervision. It seeks to promote more stable funding of banks' balance sheets.

[2] While still at the discussion stage, TLAC has the potential to also impact upon more traditional forms of bank debt, if it is decided that senior debt should be 'bail-in-able' as well at the discretion of the regulator.

The standard establishes a minimum stable funding requirement based on the liquidity characteristics of a bank's assets and off-balance sheet activities over a one-year time horizon, and aims to ensure that long-term assets are financed with at least a minimum amount of stable funding[3]. The intent of the measure is to ensure that banks have sufficient stable funding to back their lending activities. To quote APRA:

*"APRA's objective in implementing the Net Stable Funding Ratio (NSFR) in Australia, in combination with the Liquidity Coverage Ratio (LCR) implemented in 2015, is to strengthen the resilience of (banks). The NSFR encourages (banks) to fund their activities with more stable sources of funding on an ongoing basis, and thereby promotes greater balance sheet resilience. In particular, the NSFR should lead to reduced reliance on less-stable sources of funding - such as short-term wholesale funding - that proved problematic during the global financial crisis."*

While the regulation is quite complex, at its simplest, retail deposits and longer-term debt are considered stable, while institutional deposits and shorter-term debt are not considered as stable and so attract higher capital charges.

APRA proposes that the NSFR will apply to those locally-incorporated banks that are also subject to the Liquidity Coverage Ratio.

### Implications for investors

Traditionally, Australian banks have used far higher proportions of short-term funding than many of their global peers. The NSFR will encourage Australian banks to access longer-dated funding sources. There are several potential implications as it is not only possible that the term to maturity of bank issuance will increase, but that there may also be greater issuance of bonds by banks.

For investors, not only may changes in bank issuance push them further out along the yield curve, but also, if bank issuance becomes a larger part of the traditional corporate bond market, those seeking increased issuer diversification may increasingly need to access global or private debt markets, i.e. ex-benchmark exposures to provide the required level of issuer diversification.

## The changing environment brings opportunities, but also risks

While the details of the impact of the changing regulatory environment on markets are still unclear, it is still possible to identify some of the broader longer-term trends which are likely to evolve over time. As this evolution occurs, investors need to ensure that they not only keep abreast of developments, but also have the flexibility within their portfolios to adapt to the changing opportunity set of fixed income investments. Investors should also be on their guard and recognise that some of these new investments will potentially have materially different characteristics to traditional investments, even though they may appear to be similar on a superficial level.

[3] APRA release 29th September 2016

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