New regulations have put Wall Street's risk transfer machine in flux

"The fact that there is derisking and deleveraging going on among the bulge bracket (banks), both from a regulatory standpoint and from a strategy standpoint, is creating a demand for some other institutions to fill that space of warehousing and managing the risk intermediation process."

– Jon Corzine, Chief Executive, MF Global
Summer 2011, The Financial Times

What is this man talking about? Risk intermediation? Risk warehousing?

Jon Corzine was right, though it did not work out well for him. Regulatory changes have put the Wall Street risk intermediation process into flux. This is creating a need for new participants to bridge risk in financial markets globally. Let me explain.

MF Global is a U.S.-based brokerage that suffered losses on European sovereign debt inventories of US$6.4 billion in August 2011. The firm's capital base of $1.5 billion was leveraged roughly 25 times to support assets of $40 billion. Moody's downgraded the firm to junk status on October 24. That led customers, depositors and lenders to cease dealings with the firm and its stock price collapsed. At time of writing, MF Global had filed for bankruptcy and Jon Corzine had resigned.

What does Wall Street do?

The public has a narrow concept of Wall Street. The conventional view is that of overpaid and under-qualified professionals trading financial instruments within the financial community without any benefit to society. This view neglects the critical role that Wall Street provides in sourcing capital and providing risk management to the real economy. All global businesses rely on Wall Street for these critical business functions.

A more accurate concept of Wall Street is that of a giant "risk transfer machine". It stands between producers and consumers, corporate and government issuers and investors. It doesn't matter whether it's credit risk, commodity risk, interest rate risk, foreign exchange risk, or equity risk – Wall Street acts as an intermediary between the participants and moves risk from one party to another (see Figure 1).

In its simplest form, Wall Street performs an agency function of matching buyers and sellers. For example, brokerages match up railroads with oil refiners to help both manage business risks. Rarely is a trade so simple, because the buyer and seller are often mismatched in many dimensions, such as volume and timing. (In fact, there may be no buyer at all at any given time.) In such cases, Wall Street firms stand in as a principal taking a long (owned) position in the seller's asset and taking a short (owed) position in the buyer's asset. The firm has performed a risk intermediation for both clients and it needs to hedge its principal exposures (also known as the risk warehouse or inventory) until they can be liquidated. In this way, Wall Street firms bridge mismatched risks across the economy and charge fees to compensate the firm's shareholders and to offset routine losses on the risks taken.

In our view, without a market-making intermediary willing to carry principal risk on certain non-fungible assets, markets will not function satisfactorily.

The capacity of brokerages to safely hold mismatched risks on their balance sheets increases the fungibility of assets in specific markets – such as bonds issued by different phone companies or electricity contracts in different months. When asset markets become more fungible they grow larger and more liquid (more easily converted into money). More liquid assets transact on tighter bid/offer spreads and therefore are less costly to liquidate. Asset buyers apply large price discounts to illiquid assets and small discounts to liquid ones. The more illiquid an asset becomes, the smaller the set of prospective buyers.

Regulatory shift

Society has rightly decided that excessive risk was taken by the banks and brokerage firms in the years leading up to and during the financial crisis. In the future, banks benefiting from taxpayer-insured deposits will be prevented from running risky inventories on leveraged balance sheets. We agree. However, society must recognize that there are trade-offs. Lower risk is like buying insurance – it's not free. The cost of capital will rise and liquidity in financial assets will fall – these are the unintended consequences of the recent financial regulation.

In the aftermath of the financial crisis, new regulations in the form of Dodd-Frank and Basel III are having far-reaching implications for global credit markets. The Dodd-Frank Act was passed in 2010 to promote U.S. financial stability by improving accountability and transparency in the financial system. Basel III, which was released in February of this year, is the new global regulatory standard for bank capital adequacy and liquidity levels. Together, they are changing the business of the global banks and broker dealers and incapacitating the Wall Street risk transfer machine.

The combination of Dodd-Frank and Basel III will decrease risk considerably, mainly by increasing the amount of equity in the banking system. A clear consequence, however, is a reduction of return on equity for global banks and broker dealers. Consider that if bank capital doubles, all else being equal, returns on capital are cut in half. To preserve returns as best as possible, banks will pursue offsets such as repricing assets and lowering compensation.

Wall Street's shrinking risk transfer capacity

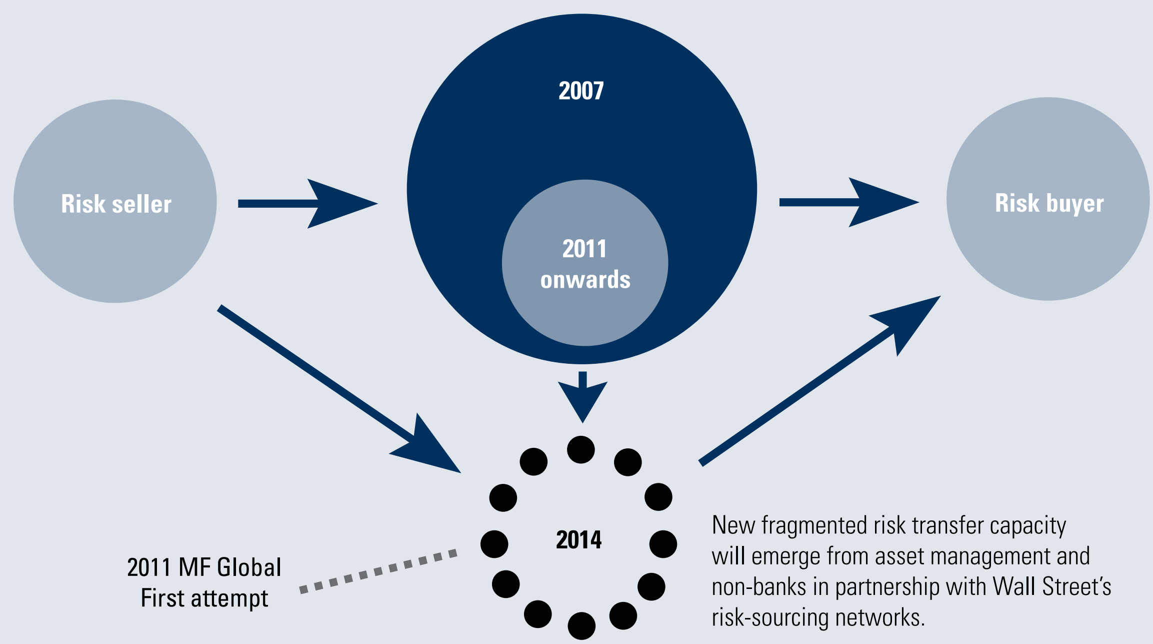


Figure 1: This graphic depicts the flows of risk through the Wall Street risk transfer machine. In 2007, broker dealers and banks had large inventories before the financial crisis. In 2011, the financial industry is undergoing regulatory reform, adapting to the new rules and shrinking its role. By 2014, we expect a new structure to evolve with institutions – such as asset managers, pension funds and private equity – becoming participants.

The summer of 2007 was the end of that era for the warehouse-and-distribute model of the risk transfer machine. The warehouse was full of leveraged buyout loans and leverage was at 50 to 60 times the capital of the bank. Under Dodd-Frank, banks will be prohibited from holding principal positions. Wall Street's inventory has been whittled down, (see Chart 1).

These two regulations have locked the door of Wall Street's warehouse so that the banks no longer have the capacity to inventory risk and gradually deplete it. Instead, the risk is forced directly into the market all at once.

When it comes to the markets, Dodd-Frank will change their structure in terms of volume, pricing, participants and volatility. Equity, rates, foreign exchange, credit and commodities markets will all see change, but not evenly. For investment banks, equity and foreign exchange businesses do not consume a lot of capital, so they will be less affected. (They are known as flow businesses where inventories tend to be low.) However, the rates, derivative and credit markets are more capital intensive and will suffer from reduced participation, higher costs and greater volatility.

In the past, regulators applied small capital charges for assets on the trading book because they were viewed as liquid securities that could be easily sold. That created an incentive for banks to hold more assets on their trading books because they could generate higher returns on equity.

Basel III is saying, "Our old policy incentivized higher risk taking, so we are changing the rules to incentivize lower risk by requiring higher capital requirements for trading assets." As this goes into force, global investment banks will shrink the inventories that underpin their trading operations. This is "game over" for the legendary risk taking on leveraged dealer trading desks and leveraged hedge funds, all of whom now fall under regulatory scrutiny. With profitability impaired, expect fixed-income business units to shrink their staffing levels considerably.

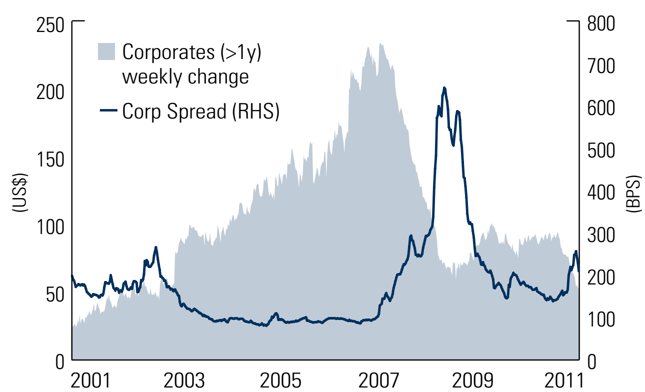
Without the warehouse-and-distribute mechanism in some markets, volatility goes up and liquidity goes down because one of the principal functions of a broker is to supply securities from inventory. Without that function, financial markets have to reprice the asset.

There still needs to be flexibility in the system to absorb risk. But it's moving from the brokers to new participants like the ill-fated MF Global, as well as the institutions that are mandated to take on risk. We expect more participation from the asset management community, including fund managers, hedge funds, pension funds and private equity, whose business model permits them to be more natural holders of risk. Structurally, those institutions should now hold more cash so that they can become the stabilizing factor when the market becomes distorted.

Another important test of the reduced risk transfer machine will come when the European banks begin to shrink their balance sheets by a trillion dollars in the wake of the European sovereign debt crisis. They have to move that credit risk through the system to Asia and North America, to banks, insurers and mutual funds. We will be watching the price distortions this causes.

Bankers are resisting the rule changes on proprietary trading and risk warehousing. In response, Paul Volcker, former head of the U.S. Federal Reserve, recently said that if the banks didn't like his rule they should look at the Glass-Steagall Act, the more draconian 1930s-era response to bank excesses that forcibly separated commercial and investment banking.

Dealer inventories & credit spreads



Source: Federal Reserve, Morgan Stanley Research

Chart 1: Already, Wall Street is showing signs that regulatory changes are starting to affect the intermediation process. Since earlier this year, primary dealers' inventories of corporate bonds have fallen off significantly, as a result, corporate bond spreads widened sharply.

Consequences

So what does this mean for us as investors?

For the economy, lower systematic risk in financial markets comes at a cost of new, higher borrowing costs. Capital will become a larger barrier to entry in industry advantaging incumbents over new entrants. This will lower growth.

For markets, it means less liquid assets are going to be repriced to compensate for lower liquidity. Some balance sheets will shrink and there may be credit rationing. Less liquidity means more volatility.

For investors, such as Signature, it's an opportunity. With our multi-assets and flexible mandates, we will benefit because when risk is being liquidated there will be bigger price distortions in markets. It also means that less liquid assets are going to have to be repriced to compensate for this new dynamic. Signature strategies have the flexibility to take advantage of these opportunities. This is the case for our income strategies, such as Signature High Income and Signature Diversified Yield, where we can look forward to higher yields as the global banking system adjusts to the new post-crisis regulatory world.

Eric Bushell
Senior Vice-President,
Portfolio Management
and Chief Investment Officer
Signature Global Advisors

CI INSTITUTIONAL ASSET MANAGEMENT

2 Queen Street East, 19th Floor, Toronto, Ontario M5C 3G7
www.ciinstitutional.com
For more information on CI Institutional Asset Management:
Please call 1.866.760.5274 Or e-mail ciinstitutional@ci.com

1111-1618_E