



Written Testimony of Mr. Robert Toomey

On behalf of the Securities Industry and Financial Markets Association

before the U.S. House of Representatives

Committee on Financial Services

Subcommittee on Capital Markets

Hearing entitled “The Impact of Regulations on Short-Term Financing”

December 8, 2016

Chairman Garrett, Ranking Member Maloney, and distinguished members of the Subcommittee, thank you for providing me the opportunity to testify on behalf of the Securities Industry and Financial Markets Association (SIFMA)¹ and to share our members' perspective on the impact of regulations on the capital markets broadly and the short-term funding markets more specifically. SIFMA applauds this Committee's focus on ensuring that an appropriate balance is struck between regulation and growth through an evaluation of the intended and unintended consequences of the post-crisis reforms. Much of the regulation that has been implemented seeks to address key contributors to the financial crisis and has made both banks and the broader financial system safer and sounder through new heightened prudential standards and higher and better quality capital, leverage and funding rules. In addition, the Basel Committee, the Financial Stability Board, and several U.S. regulators continue to seek additional reforms that have yet to be fully implemented and whose effects are not yet baked into the system or the cost of capital.

It is often noted by this Committee that the U.S. financial markets are characterized by their unparalleled size, depth, dynamism, diversification, and resiliency. Our capital markets allow the Federal government, state and local governments, corporations and investors quick and efficient access to financing. Moreover, the depth and liquidity of U.S. secondary markets, particularly the fixed income markets, permit those entities to access capital and credit with greater availability at a lower cost over time.

¹ SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$20 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

Policymakers have clearly stated that many of the post-crisis reforms were designed to solve for what they saw as too little capital, lax underwriting standards and excess market liquidity that was insufficient during periods of credit stress. But recently, market participants and observers have raised concerns that the reforms may have resulted in reductions in market liquidity beyond what was intended, particularly for the high-quality liquid assets that underpin the financial system and our economy.

We see the resiliency and depth of market liquidity as a critical objective for policymakers and market participants alike. Again, the depth and liquidity of U.S. capital markets is among the primary reasons it leads the world in size and use, and to great benefit to the broader economy. If market participants' ability to access liquidity is impaired, particularly during stress periods, it will negatively impact functioning of financial markets with broad ramifications for the general economy. Indeed, this is what we experienced in 2007-2008 when markets froze, particularly short-term markets, putting severe funding pressure on both the private and public sector. Regulations that are risk-insensitive, and regulations that target the same risk multiple times through multiple rules, weigh particularly heavily on low-risk assets. While the broad contours of the new capital and liquidity rules have been known for some time, the implementation phase is just gathering force and indeed, some rules remain to be proposed and finalized.

Assessment of the Regulatory Framework Needed

As such, we believe now is an appropriate time to assess the coherence of the existing framework, and the degree to which overlapping rules target the same risks. We are thus recommending an assessment of coherence and cumulative impacts, on a forward-looking basis, to identify cases where there may be unnecessary duplication or conflicts between specific regulatory requirements and broader policy goals. Such an assessment could identify opportunities to add liquidity back to the

market without adversely affecting the safety and soundness of individual banks or of the overall financial system. In this testimony, we identify potential, but not exhaustive, areas of concern.

First, we believe that the impact of risk-insensitive rules on client trades that are designed to reduce risk is inconsistent with the policy objectives of capital and prudential regulations.

Second, in looking at the full rule-set in place today and what we expect to come online in the near future, we find duplications and inconsistencies between the rules that together could have negative effects.

Third, and related to our first point, the treatment of low-risk, high-quality assets like cash and cash equivalents varies depending on the rule and often does not reflect their low-risk or risk-free status.

Finally, the assessment should examine the calibration of specific rules that are designed to serve as backstops but that actually operate as binding constraints.

Where new regulations such as the leverage ratio and Net Stable Funding Ratio (NSFR) interact with other rules and changes in market structure to further reduce market liquidity, users of financial services could be prevented from achieving their investing, capital-raising or risk-management goals, undermining the critical role of capital markets in the economy. While it has been observed that the average size of trades has shrunk during the implementation of the post-crisis regulatory reform package, indicating less immediacy of execution and higher execution costs in most asset classes, investors have shown an ability to absorb some of the execution risks in day-to-day markets.

However, under the new rules they may not be able to transact effectively in stressed markets, when the need to sell is acute and delays can drive sharper price dislocations.

Impact of Regulation on the Repo Market

Short-term funding markets play an essential function in the financial system. Indeed, as we have noted most recently in our comment letter on the proposed Net Stable Funding Ratio, “[r]epo transactions play a vital role within the financial system and underpin the functioning of the capital markets, including the market for U.S. Treasury securities, collateral management and money markets.”² Repo markets provide the necessary grease that allows the U.S. capital markets to remain the most efficient and liquid in the world so that businesses, municipalities and the Federal government can access needed credit at the lowest cost over time. A well-functioning repo market decreases the overall cost of borrowing and provides a mechanism for the efficient management of short-term cash and collateral requirements.³

Investors rely on the repo market as an essential part of their activities. Reverse repos are a safe way to invest cash, while repos allow investors to finance inventory, enhance yield in a safe and proven manner and quickly generate cash needed for redemptions.

Several significant regulations, some of which are not fully in place yet, have been proposed and/or adopted that have a direct impact on the repo market and other short-term funding markets. While some of these impacts are clearly intentional and reflect a policy concern for overreliance by financial institutions on short-term funding, we believe that as a result of the cumulative impact of these regulations, the repo market is being impacted in ways that do not reflect either the risk to the financial system or to individual firms.

² SIFMA with other trade associations comment letter on NSFR Proposed Rule, August 5, 2016, available at <http://www.sifma.org/issues/item.aspx?id=8589961839>

³ A robust repo market aids in limiting settlement fails by providing a ready supply of securities to market participants to alleviate short supplies or operational issues that may occur from time to time.

Given the overall importance of the repo markets to the cash markets, particularly the markets in fixed income securities, as a source of securities and as a repository for short-term investable cash, constraints on the liquidity in the repo market constrain liquidity in the cash markets to the ultimate detriment of the users of capital markets—the Federal government, municipalities and businesses both large and small.

Other rules, while not directly targeting the reliance of firms on short-term funding, will also have an impact on these markets by creating demand for a liquid repo market at the same time regulations are causing market participants to limit repo intermediation. Each of these rules may impact the short-term funding markets in different ways but the overall interaction of these regulations—and thus any unintended consequences for efficient capital formation—is unclear. Indeed, the aggregate impact of these reforms can be far greater than the intended impact of the individual reforms. These aggregate impacts can result in less access to credit, and higher costs for corporates, governments, and investors, impeding economic growth.

Within the short-term funding markets, and in response to the financial crisis, much has been done to improve resilience and lessen systemic risk. Reforms in the tri-party repo market, for example, eliminated over 95% of the significant intraday credit that was being extended by the clearing banks to dealer firms. This development lessens the risk that the market poses to the broader financial system. Individual firms, heeding the lessons of the financial crisis, improved risk management practices and recognized the need to diversify funding sources and to provide for a variety of maturities for repo transactions, thus lessening reliance on overnight funding.

Publicly available data illustrates the changing size and profile of the repo market, both in reaction to changes in prudential regulation and through the adoption of changed risk management practices.

Aggregate repo volumes in the U.S. have contracted significantly since 2008: Federal Reserve data shows that aggregate daily repo volumes in the U.S. have contracted from \$3.9 trillion in 2008 to \$2.4 trillion in 2014.⁴ In addition, the mix of collateral subject to outstanding repos has changed, with a larger portion of non-Treasury securities now making up the collateral mix.⁵

Supplementary Leverage Ratio

The financial crisis of 2008-2009 revealed weaknesses in the prudential framework for banks. As previously noted, international and U.S. bank regulators along with the Congress have sought to strengthen this framework through a number of initiatives. There is widespread agreement that prudential reforms put in place following the financial crisis, aimed at both capital and liquidity, have helped create a system that is now more resilient and better able to withstand shocks.

While addressing some of these weaknesses through a revision to the risk-based prudential framework, policymakers also focused on strengthening the leverage ratio. The Supplementary Leverage Ratio (SLR) was first proposed in the U.S. in 2012 and finalized in 2013. U.S. banks subject to the SLR began disclosing and reporting ratios in 2015, and must be compliant by 2018.

Broadly speaking, the SLR seeks to create a prudential back-stop to the enhanced risk-based capital requirements. The ratio, in summary, contains two measures: a numerator that represents the tier 1 capital of the institution and a denominator that represents total exposures. Total exposures for purposes of the SLR includes on-balance and off-balance sheet assets, including repo-style

⁴ See Global financial markets liquidity study, PwC, (August 2015), available at <http://www.pwc.com/gx/en/financial-services/publications/assets/global-financial-market-liquidity-study.pdf>

⁵ See OFR Working Paper, “Do Higher Capital Standards Always Reduce Bank Risk? The Impact of the Basel Leverage Ratio on the U.S. Triparty Repo Market,” Meraj Allahrakha, Jill Cetina and Benjamin Munyan (November 2016) (OFR Paper): “...[F]ollowing the 2012 introduction of the [SLR], broker-dealer affiliates of [bank holding companies] decreased their repo borrowing but increased their use of repo backed by more price-volatile collateral.”

transactions. Notably, the SLR does not risk weight the assets in the exposure measure. Thus, the measure included in the exposure denominator treats all assets the same for SLR requirements. For instance, Treasury securities and cash are treated the same as unsecured loans and other more volatile securities.

While the SLR is intended to be a backstop measure to risk-based requirements, for many institutions it may become the binding constraint. This has implications for the smooth functioning of the short-term funding markets, particularly the repo market for U.S. government securities. As noted, the SLR is not risk-based and the calculation includes exposures for all repo transactions and makes no distinction between repos (and other financings) involving U.S. Treasury securities and those involving other assets. This creates two significant issues for the repo market: (1) it results in higher capital costs for dealer intermediation in the Treasury repo market; and (2) incentivizes for the substitution of Treasury repos with repos using collateral with a higher risk profile.

The SLR has sharply increased the cost for use of a bank's balance sheet in a traditional matched-book repo arrangement. On a typical repo trade, a bank/dealer may lend cash to a counterparty who secures the loan with Treasuries. The Treasuries may then be financed by the bank/dealer through another repo at a, usually, lower financing rate. If a counterparty fails, the position can be liquidated with very low risk to the bank/dealer because it is almost fully secured or over-secured by cash or safe Treasuries. The SLR makes this important sequence of transactions significantly more expensive from a capital perspective. For the largest U.S. banks, the SLR now requires 6% capital for all assets regardless of risk.⁶ Safe Treasuries and cash are subject to the same capital treatment as less safe assets. As a result, intermediaries in the repo market for Treasuries -- generally a low

⁶ We include the impact of the U.S. G-SIB surcharge as implemented in the U.S. which also measures reliance of short-term wholesale funding such that a banking organization that engages in a large number of matched-book repos which have a higher G-SIB surcharge.

margin business -- would have to require profits for Treasury repo that would be comparable to transactions in riskier assets. Dealers associated with banks subject to the SLR thus have hard balance sheet constraints that may limit the ability to intermediate some repo classes.⁷

Liquidity Coverage Ratio

The Liquidity Coverage Ratio (LCR) has led to an additional stress on liquidity in the repo market by imposing requirements on subject institutions to have on hand sufficient high quality liquid assets (HQLA) to weather a short-term (30 days) liquidity stress event. Thus, demands for HQLA, in particular U.S. Treasury securities, will increase because of the LCR. Further, during a market stress firms can be expected to hoard HQLA to meet liquidity requirements and not make such securities available in the repo market, adding additional liquidity pressures. Finally, demand for HQLA from banks and dealers will compete with money market funds, particularly government-only funds. These funds have increased significantly in size since the implementation of recent money market reforms and will add to demand pressures in an environment where, due to other requirements, repo supply may be diminishing.

Net Stable Funding Ratio

The proposed NSFR would further unduly add costs to safe matched-book activities. Under the NSFR proposal, repos and reverse repos would be subject to asymmetric treatment in that short-term funding from financial sector entities received by a subject entity is assigned 0 percent Available Stable Funding (ASF), whereas short-term lending to financial sector entities by a subject entity is assigned a 10 or 15 percent Required Stable Funding (RSF) factor (depending on the quality of the assets underlying the repo transaction and whether the subject entity has rights of

⁷ See OFR Paper

rehypothecation with respect to the underlying assets). Thus, the proposed rule would require a subject entity to hold stable funding against a repo book that is perfectly matched, effectively imposing yet another tax on these transactions, even though the repo market for U.S. Treasuries and related assets should be considered low risk. Elimination of the asymmetrical treatment of the two legs of the matched transactions would alleviate this additional pressure on this low risk activity.

Volcker Rule

Finally, the Volcker Rule, with its limits on proprietary trading, exerts further liquidity pressure in the cash markets. SIFMA has long held the position that the Volcker Rule was a solution in search of a problem and that it did not address issues identified in the financial crisis. SIFMA members have implemented the Volcker Rule requirements, including the restrictions on proprietary trading, over the last several years. Implementation challenges remain as firms continue to put in place policies and procedures that would recognize the distinction between prohibited prop trading and permitted market making activities. We believe the approach to market making adopted by the Final Rule is complex and may make it difficult for firms to distinguish between permitted and proscribed activities. Thus, firms may limit their intermediary activities even more to ensure overall compliance with the prop trading restrictions.

In addition, implementation of the Volcker Rule over the last few years has indicated the need for a more coordinated approach to regulatory cooperation, particularly with respect to regulatory interpretations and supervision. A more transparent and cooperative regulatory/interpretive oversight regime would aid firms as they become compliant and limit the doubts that may cause further pull back from needed customer activity.

Conclusion

The short-term funding markets remain vitally important to the efficient functioning of our capital markets. In response to lessons learned from the financial crisis and regulatory prescriptions, the repo market has shrunk and firms' reliance on short-term wholesale funding has been reduced.

However, through overlapping and non-risk sensitive rules regulators may be impinging on valuable liquidity and efficiencies this market provides and lessening liquidity in the cash markets. That is why it is essential that an assessment of the cumulative impact and interaction of these rules is undertaken to ensure harm is not being done to this crucial market.

Through the leverage ratio requirements firms are facing clear and rigid limits on the size of their balance sheets and this inelasticity, particularly with respect to safe U.S. Treasury securities and cash, will limit important dealer intermediation. Indeed, we are seeing these impacts now as the size of the repo market decreases and the mix of collateral changes. Further pressures on Treasury repo include requirements to hold HQLA -- a requirement which will create further significant pressures during stressed situations -- recent changes to the money market rules which create more demand for U.S. Treasury repo, and the proposed NSFR which imposes yet another tax on safe matched book Treasury repo activity.

We believe that given the experience and market data from the introduction of these new approaches, the time is right to provide a wholesale review of the impact and coherence of these requirements with a view towards moving towards a better balance of safety and soundness with efficiency, liquidity and capital availability. As liquidity diminishes or becomes more brittle in these markets, higher costs of capital may be inevitable for both the government and Main Street.