

# Regulatory Changes in the Investment Banking Industry

**How investment banks can prepare themselves to cope with evolving regulations**



**People matter, results count.**

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# 1. Introduction

Although the worst might be over, the investment banking industry is still recovering from the aftermath of the financial crisis. The post-crisis period has witnessed a flurry of regulatory activity, with more stringent and intrusive regulations being the order of the day. Some of the regulations whose provisions are going to have an impact on one or more aspects of the investment banking industry include:

- The Dodd-Frank Act
- Basel III
- Markets in Financial Instruments Directive (MiFID)
- European Banking Authority (EBA) Governance Guidelines
- Financial Stability Board (FSB) Principles
- European Market Infrastructure Regulation (EMIR)
- Foreign Account Tax Compliance Act (FATCA)
- Financial Transaction Tax (FTT) Act

The scope and geographical relevance of these regulations might differ, but all of them mandate the imposition of more stringent regulatory norms on financial institutions. All aspects of the investment banks' business—capital, liquidity, systemic risk, supervision, governance, remuneration, traded market—are expected to be affected by one or more of provisions of these evolving regulations.

This whitepaper will look at the impact of evolving regulations on the investment banking industry and will provide some high-level guiding principles for coping with the new regulatory environment.

## 2. Overview of the Investment Banking Industry

Capital raising, proprietary trading, and deal underwriting are some of the core activities typically carried out by investment banks.

The primary activity of investment banks is client servicing, which includes helping clients raise equity capital by underwriting initial public offerings and facilitating private placement of shares, raising debt capital, facilitating mergers and acquisitions, and managing investments. Investment banks are also involved in ancillary activities such as proprietary trading, investing, and the development and sale of equity and debt products.

Typically, an investment bank has a three-layered structure comprised of front, mid, and back offices, though there can be variations based on the size of operations. The front office is involved in activities such as assisting organizations in mergers and acquisitions, providing investment management services to institutions and high net worth individuals, formulating strategy, and developing investment research reports. The typical functions of the mid-office are risk management, equity research, internal strategy development, organizational controls implementation, and compliance with regulatory norms. Finally, the back office is tasked with maintaining trading platforms, devising new trading algorithms, handing trade confirmations, and ensuring correct execution and settlement of securities.

### 2.1. Financial Performance

While revenues registered by investment banks improved between Q2 2012 and Q1 2013, the industry has suffered an approximate decline of more than 30% in revenues between 2009 and 2012<sup>1</sup>. The major reason for this sharp drop is the decline in business from their clients with income from trading bonds, currencies, and commodities. These areas have suffered because of the discouraging impact that slowing economies and turmoil in Europe have had on institutional investors. Another major reason for the drop in revenues are regulations governing capital and liquidity, which are reducing returns earned by banks and are forcing them to shrink their balance sheets and cut back on trading.

Nevertheless, there have been some bright spots on the profitability front with some leading investment banks having reported higher than expected profits in the first quarter of 2013. For example, the pre-tax profit of Barclays' investment banking unit rose by 11%<sup>2</sup> and Nomura's first quarter profits more than tripled from last year, owing to a surge in the investment banking fees and brokerage commissions<sup>3</sup>.

From a regional perspective, the U.S. continues to remain the key region for the investment banking industry, and accounted for around half of the industry's revenues in 2012. However, the revenues of the investment banking industry declined across most regions between the fourth quarter of 2012 and the first quarter of 2013, with the U.S. region witnessing a decline of 6.1% in revenues. The primary reason for the drop in revenues was reduced activity in mergers and acquisitions which declined from \$303.9 billion in the fourth quarter of 2012 to \$239.4 billion in the first quarter of 2013. Mergers and acquisitions activity witnessed a decline in Asia and Latin America too, thereby resulting in the decline of their revenues for the same period<sup>4</sup>.

<sup>1</sup> "Dream turns to nightmare" The Economist, Sept. 15, 2012, <http://www.economist.com/node/21562925>

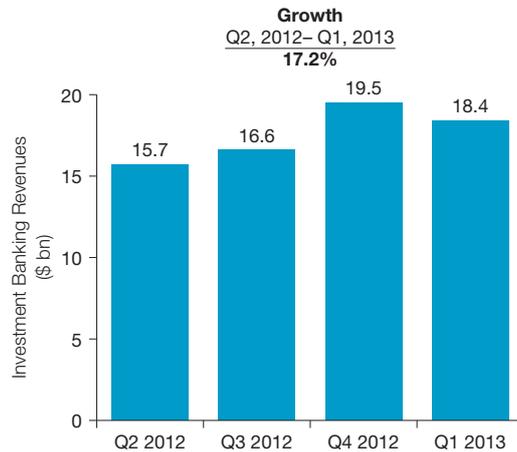
<sup>2</sup> <http://www.efinancialnews.com/story/2013-04-24/barclays-group-results-q1-2013?ea9c8a2de0ee111045601ab04d673622>

<sup>3</sup> <http://www.bloomberg.com/news/2013-04-26/nomura-quarterly-profit-beats-estimates-on-investment-banking.html>

<sup>4</sup> All statistics from The Investment Banking Scorecard", Wall Street Journal, [nd], [graphicsweb.wsj.com/documents/INVESTMENT/InvestmentBankQuarterly\\_1007.html](http://graphicsweb.wsj.com/documents/INVESTMENT/InvestmentBankQuarterly_1007.html)

Exhibit 1: Global Investment Banking Revenues, (\$ bn), Q2 2012 to Q1 2013

The investment banking industry's revenues have been declining due to a depressed economic climate and constraints imposed by regulations on capital.

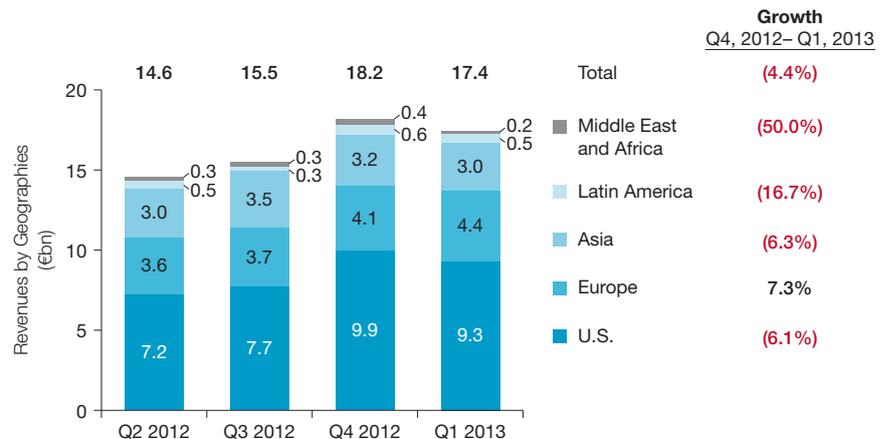


Source: "The Investment Banking Scorecard", Wall Street Journal, [nd], graphicsweb.wsj.com/documents/INVESTMENT/InvestmentBankQuarterly\_1007.html

In Europe too, mergers and acquisitions declined significantly and came down from \$264.4 billion in the fourth quarter of 2012 to \$167.3 billion in the first quarter of 2013. However, debt capital markets volume increased from \$465.4 billion in to \$701.2 billion in the same period, resulting in higher revenues for the investment banks<sup>5</sup>.

Exhibit 2: Global Investment Banking Revenues, by Region, (\$ bn) Q2 2012 to Q1 2013

The economic uncertainty plaguing the global economy has resulted in reduced mergers and acquisitions activity across regions.



Source: Capgemini Analysis, 2013; "The Investment Banking Scorecard", Wall Street Journal, [nd], graphicsweb.wsj.com/documents/INVESTMENT/InvestmentBankQuarterly\_1007.html

<sup>5</sup> "The Investment Banking Scorecard", Wall Street Journal, [nd], graphicsweb.wsj.com/documents/INVESTMENT/InvestmentBankQuarterly\_1007.html

## 2.2. Evolving Regulations

In the aftermath of the financial crisis, a spate of regulations has evolved which are expected to have an impact on multiple facets of the investment banks' business. The following exhibit provides a summary of these regulations along with the regions in which they are expected to have an influence and the areas of business that they are expected to impact.

Exhibit 3: Summary of Key Emerging Regulations Impacting the Investment Banking Industry

Regulation	Impacted Region	Capital	Liquidity	Systemic Risk	Supervision	Governance	Remuneration	Traded Market	Financial Crime
Dodd-Frank	U.S.	✓		✓	✓		✓	✓	
Basel III	Global	✓	✓						
Capital Requirements Regulation (CRR)	Europe	✓	✓						
Capital Requirements Directive (CRD 4)	Europe	✓				✓			
Markets in Financial Instruments Directive (MiFID 2)	Europe					✓			
European Banking Authority (EBA) Governance Guidelines	Europe					✓			
Financial Stability Board (FSB) Principles	Global				✓		✓	✓	
European Market Infrastructure Regulation (EMIR)	Europe								✓
Foreign Account Tax Compliance Act (FATCA)	U.S.								✓
Financial Transaction Tax (FTT)	Europe								

The post-financial crisis period has witnessed the emergence of a series of regulations impacting the different aspects of the investment banking business.

While the modalities and scope of these regulations may vary, they share the same high-level objectives (though variations may be present):

- **Increase Consumer Protection:** Make the process of providing investment advice to customers more transparent and ensure that investors are aware of the potential downside risks associated with the investments they are making.
- **End Too Big to Fail Bailouts:** Ensure that firms have an adequate capital cushion and sufficient liquidity to carry on business in the event of adverse business outcomes. Ensure that firms do not take excessive risks and do not develop scales which pose systemic risks.
- **Implement Early Warning Systems:** Ensure transparency and accountability for credit rating agencies to protect investors.
- **Improve Transparency and Accountability of Exotic Instruments:** Eliminate loopholes in the current financial architecture that allow risky and abusive practices to go unnoticed and unregulated.
- **Improve Corporate Governance:** Provide shareholders with a say on executive compensation and corporate affairs and ensure that executive compensations are structured in a way that principal-agent problems do not arise.
- **Enhance Regulations on the Books:** Strengthen oversight and empower regulators to pursue conflicts of interest, financial fraud, and manipulation of the system aimed at benefiting special interests.

The process of rule-making and drafting of regulations is still in a nebulous phase with multiple regulations and provisions being drafted/ modified in parallel. This is expected to create challenges for the investment banking industry.

## 3. Implications of Regulatory Changes

The emerging regulations may curtail the investment bank's revenue generating potential, strain their cost structure, and likely reduce the return on investment of their business lines.

The evolving regulations impacting the investment banking industry are expected to have a two-fold impact on the performance of investment banks:

- The new regulations are expected to impact an investment bank's financial performance by restricting their revenue-generating potential, putting a strain on their cost structure, and reducing the returns of their different business lines.
- These regulations are also expected to impact the operations and business models of the investment banks by enhancing their reporting requirements; putting constraints on their structuring, clearing, and trading of derivatives; requiring a recovery and resolution plan; and putting limits on executive compensations while mandating more stringent governance standards.

### 3.1. Strain on Financial Performance

#### Restrictions on Revenue Generation Potential

Proprietary trading has traditionally been one of the major sources of revenue for investment banks. However, one unifying theme that runs through most major regulations that have evolved in the post-crisis period has been the restrictions they seek to impose on this practice. Consequently, it is expected that some business lines of investment banks may become economically unviable, which will in turn have a negative impact on their revenues.

According to the Basel III proposals, the imposition of a Tier 1 leverage ratio of 3% is being planned, which will limit banks' total assets to 33 times their capital<sup>6</sup>. This will put severe restraints on the risk-taking activities that investment banks may participate in and thereby restrict their revenue-generating potential.

Finally, the revenues of investment banks are also expected to come under strain as a result of a mandatory shift of most over-the-counter derivatives to central counterparties. As a result of this shift, investment banks will be able to charge lower margins for centrally-cleared products (generally 40% to 50% less than over-the-counter products).

#### Strain on the Cost Structure

The new regulatory provisions are also expected to strain various aspects of the investment banks' cost structure, such as asset holding, funding cost, capital cost, and counterparty credit risk charge.

**Asset Holding:** The evolving regulations will make it compulsory for banks to increase their holding of high-quality liquid assets that can be used as a buffer against high-volume cash outflows during times of crisis. This will mean that banks will have to invest more in lower-yielding assets, which will in turn have an adverse impact on their profitability.

**Funding Costs:** The funding costs of banks will increase as a result of the regulatory requirement to reduce the maturity mismatch by increasing the level of more expensive and long-term funding.

**Capital Costs:** The provisions of evolving regulations mandate the imposition of additional capital charges for stressed value at risk for all products, imposition of an incremental risk charge and a securitization charge, and implementation of comprehensive risk measures for proprietary trading and credit and rate products. These additional charges and levies are expected to more than double the capital requirements for supporting the market-risk weighted assets for most products (the increase in capital requirements might even be up to six times for products such as structured credit).

<sup>6</sup> "The New Basel III Framework: Implications for Banking Organizations", Shearman & Sterling LLP, March 2011, [http://www.shearman.com/files/Publication/f4e80b99-f0a1-4e3a-90f0-3bf21c7d0ce0/Presentation/PublicationAttachment/8d4e19cc-1ba3-4501-8fe6-63a6633d5b6b/FIA-033011-The\\_new\\_Basel\\_III\\_framework\\_\\_Implications\\_for\\_banking\\_organizations.pdf](http://www.shearman.com/files/Publication/f4e80b99-f0a1-4e3a-90f0-3bf21c7d0ce0/Presentation/PublicationAttachment/8d4e19cc-1ba3-4501-8fe6-63a6633d5b6b/FIA-033011-The_new_Basel_III_framework__Implications_for_banking_organizations.pdf)

While all business lines of investment banks will be negatively impacted by regulations, the structured credit business will be the worst impacted.

An increase in Tier 1 Capital Ratio is also proposed which is expected to adversely impact the cost structure of all business units of an investment bank. It may also render un-viable some heavy-risk businesses for whom the impact of the increased capital requirements is expected to be the most severe.

**Counterparty Credit Risk Charge:** In order to address the increased risk that non-centrally-cleared over-the-counter contracts pose, the regulations mandate the imposition of an additional credit valuation adjustment. This adjustment factors in parameters such as maturity and creditworthiness of the counterparty, and the extent of collateralization. This will translate into higher charges for low-quality counterparties and longer-duration contracts. The result will be a significant increase in the current counterparty credit risk charge for investment banks.

It is clear that the profitability of investment banks is certain to come under strain as a result of the evolving regulations. Exhibit 4 provides a snapshot of the impact that that evolving regulatory provisions will have on the return-on-equity of major investment banking business lines.

Exhibit 4: Impact of Regulations on RoE of Investment Banking Business Lines

Regulation	Market-Risk Framework	Counterparty Credit Risk	OTC shift	Capital Ratio	Leverage Ratio	Liquidity and Funding Cost	Delta ((Post Regulation RoE-Pre Regulation RoE)/Pre Regulation RoE) (%)	Degree of Impact on RoE
Foreign Exchange	(8%)	0	0	(4%)	0	(2%)	(45%)	Yellow
Flow Rates	(6%)	(5%)	3	(2%)	0	(1%)	(60%)	Orange
Structured Rates	(4%)	(6%)	0	(1%)	0	(1%)	(80%)	Dark Red
Flow Credit	(8%)	0	(1%)	(1%)	0	(1%)	(65%)	Orange
Structured Credit	(9%)	(2%)	0	(1%)	0	(1%)	(85%)	Dark Red
Commodities	(6%)	(3%)	0	(2%)	0	(2%)	(60%)	Orange
Cash equities	(5%)	0	0	(3%)	0	(2%)	(40%)	Yellow
Flow Equity Derivatives	(8%)	(1%)	(3%)	(2%)	0	(2%)	(65%)	Orange
Structured Equity Derivatives	(10%)	(4%)	0	(2%)	0	(2%)	(70%)	Dark Red
Prime services	0	0	0	(3%)	(3%)	(1%)	(45%)	Yellow
Proprietary Trading	(22%)	(1%)	(1%)	(2%)	0	(2%)	(80%)	Dark Red

Source: Capgemini Analysis, 2013; Böhme et al., "Day of Reckoning: New regulation and its impact on capital-markets businesses", McKinsey & Co., Sept. 2011, [http://www.mckinsey.com/App\\_Media/Reports/Financial\\_Services/McKRegulation\\_capital\\_markets.pdf](http://www.mckinsey.com/App_Media/Reports/Financial_Services/McKRegulation_capital_markets.pdf)

Meeting reporting requirements would need substantial investment of financial resources and management time.

## 3.2. Impact on Operations and Business Model

Four regulatory drivers are expected to have a profound impact on the operations and business model of investment banks.

### Driver 1: Need for Recovery and Resolution Plan

Constructing a credible recovery and resolution plan might entail changes in business activities, operational structures, and legal entities, all of which is expected to increase the cost burden on effected institutions. Investment banks will also face additional costs in creating and implementing contingency plans, and reporting the recovery and resolution plans to the authorities. Investments will also have to be made in the creation of a robust, properly ring-fenced, and holistic management information system that can limit intra-group exposures and thereby support the resolution planning. Finally, investment banks will also have to create in-service legal agreements which can be invoked in times of crisis when resolution might be required.

### Driver 2: Constraints on Structuring, Trading, and Clearing of Derivatives

Under new regulations the operating structure and legal entity status of investment banks will be subject to more intrusive regulatory scrutiny, which might impose restrictions on the range of business activities which they might engage in. The provisions around standardization and centralized clearing of over-the-counter derivatives are expected to increase the cost of capital for firms and investors alike. It is also likely to make the process of risk management more complicated and expensive. Moreover, the operational complexity in the way investment banks achieve the best execution for their clients is also expected to increase. Finally, many participants may see themselves getting forced out of the market as a result of the new rules pertaining to electronic trading of derivatives. This may have a negative impact on the liquidity of the market which will in turn result in higher capital costs and higher operating costs for market participants.

### Driver 3: Enhanced Reporting Requirements

Investment banks will have to make concerted investments in their reporting capabilities to ensure that they meet the information requirements mandated by regulations. They will also have to develop the capability for carrying out more detailed stress testing that gives a clearer picture of the risk they face. This would involve creation of new data repositories, improvement of data quality, and improvement of systems and processes in a manner which facilitates carrying out of scenario-based stress testing on a flexible and ongoing basis. Finally investment banks will also have to invest in developing capabilities which enable them to carry out the reporting required for imposing new levies and taxes and reporting trades.

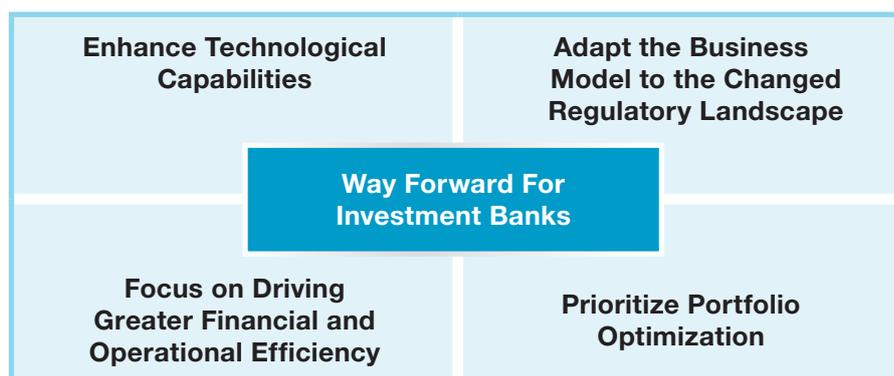
### Driver 4: Limit on Executive Compensation and Enhanced Governance Standards

Considerable management time and effort will have to be spent on the evaluation of governance structure, setting up a business continuity plan which meets the regulatory requirements, and establishing risk tolerance levels. The need to ensure that executive compensation does not adversely impact the bank's capital position or its ability to handle future business risk might hinder the bank's ability to offer the most competitive/lucrative compensation to executives. This might adversely impact the banks' ability to attract and retain the best talent. Instead considerable time and effort would have to be spent on making a business case for offering high compensation to top executives. Also, the imposition of claw-back clauses (which link the employees' bonuses to the performance of financial products which they might create) would mean that senior executives would refrain from taking risky business decisions. This might result in the bank losing out on gains which could have been made by taking calculated risk. Finally, banks will have to reassess their organizational structure to bring it in line with the risk profile of their business.

## 4. The Way Forward

The regulatory landscape for the investment banking is changing rapidly and investment banks must brace themselves for an era of heightened regulatory oversight. There are a number of areas to which investment banks should direct their attention in order to effectively cope up with the impact of evolving regulations.

Exhibit 5: Way Forward for Investment Banks



Source: Capgemini Analysis, 2013

### Adapt the Business Model to the Changed Regulatory Landscape

As was discussed in a previous section, the impact of the evolving regulations will vary from one business line to another, with businesses such as proprietary trading and structured credit being among the worst hit. Also, the major factor which will drive down the return on investment of investment banking business lines such as proprietary trading and structured credit will be the market risk framework of Basel 2.5 which imposes additional charge for risk-related products, thereby increasing the amount of capital which banks should set aside for covering market risk.

Given the changed scenario, it is recommended that investment banks perform a viability analysis of each business lines by factoring in the capital requirements. Based on the results, some business lines may prove to be economically unviable.

Alternatively, investment banks can also explore the option of outsourcing or relocating some of their business activities. While such decisions will be based on the circumstances unique to each financial institution, the transactional nature of trading operations and market making make these areas suitable candidates for relocation.<sup>7</sup>

Given the capital and liquidity constraints that the evolving regulations impose, it is recommended that institutions reevaluate the length, breadth, and depth of their operations. Investment banks will do well to evaluate where their core competencies lie, identify the critical markets where they have a strong presence, pinpoint key services where they have a competitive edge, and assess key needs of their client base. From this assessment, investment banks can decide on the most appropriate business model.

<sup>7</sup> "Change amidst uncertainty: how banks are adapting to the emerging regulatory Landscape", Economist Intelligence Unit, CAPCO, <http://www.managementthinking.eiu.com/sites/default/files/downloads/Change%20amidst%20uncertainty.pdf>

### Prioritize Portfolio Optimization

Given the additional constraints that new regulations impose on the capital of investment banks, it's important to make the best use of resources and optimize the active portfolio. Institutions should ensure that sufficient portion of the portfolio is invested in liquid assets and the asset mix does not end up creating additional capital requirements. At the same time, institutions must take steps towards portfolio optimization. Unwinding positions which are unviable from a capital requirement perspective can potentially be the first step.

Additionally, investment banks must mitigate the impact of credit valuation adjustment (CVA) which will impose additional capital requirements on OTC transactions. One potential method to alleviate CVA impact is to ask clients to post collateral. Alternatively, institutions can treat existing client savings as collateral against their OTC trades. This alternate approach is limited to deposit-taking investment banks.

Investment banks can also explore ways to restructure products and reduce the duration of derivative contracts so as to curtail exposure levels and CVA capital requirements.

Finally, investment banks can look to employ hedges more effectively to manage CVA capital charge requirements. Basel III norms allow the use of single name credit default swaps (essentially an insurance against the default of reference entity) and contingent credit default swaps (which are triggered by a pre-defined credit event) for discounting the CVA charge. Use of such instruments should thus become an integral part of investment banks' portfolio optimization and capital charge minimization strategy.

### Focus on Driving Greater Financial and Operational Efficiency

Given the liquidity and capital constraints that the evolving regulations are expected to impose on investment banks, it is imperative that they take immediate steps to increase financial efficiency. To do so, institutions should first have a look at collateral management systems which have traditionally been led by the back office and involve siloes based on product lines. Such an approach may mean a bank does not have a clear view of the liability of their clients. Today, many collateral management systems operate based on information that is available from end of day reports. As a result, intra-day management of collateral (and the risk implied therein) is not possible which leads to key decisions (such as those pertaining to margin calls) being taken on the basis of data that is not real-time.

Collateral management system may be ill equipped to deal with new regulatory requirements that necessitate the separation of CCP and client collateral, accommodation of new types of collaterals, and real-time valuations to the front desk. As a result, many investment banks will need to upgrade their collateral management systems to enable them to accept the full range of products as collaterals. Also, these system may need to be updated to ensure the calculation of exposures is made on a real-time basis and netting of positions is made on a cross-product basis so as to provide a single view of each client's positions to optimize the process of margin collection.

Apart from upgrading collateral management systems, investment banks also need to explore ways to manage their cost structures in a more aggressive fashion. To that end, it's important to rationalize headcount in business lines whose prospects are expected to suffer the most as a result of evolving regulations. Business lines may want to adopt a risk-adjusted approach towards compensation and adapt

compensation structures accordingly. Additionally, investment banks should also look for ways to increase the use of central counterparties and exchange trading by putting in place the necessary infrastructure and by standardizing their contracts.

In order to improve operational efficiency, investment banks should look to minimize manual workflows by focusing on process automation as a continual and ongoing process. Typically, any manual intervention in a process should be considered an exception, and the ongoing objective is to modify processes so an automated solution to the exception can be found and implemented. Every manual process that becomes automated can reduce costs.

Investment banks should look at ways to increase client self-servicing—especially for operations which involve provisioning of data or information—by developing client portals which house the most popular reports and data. The information on client portals should be made available in a format which is aligned with the client’s end objective. Doing this can help reduce support staff which in turn translates into lower costs for people, infrastructure and maintenance.

### Enhance Technological Capabilities

The new regulatory provisions will impose additional reporting conditions on institutions. Since firms will need to furnish information around executed swap trades, they must put in place the necessary reporting infrastructure to provide this information to regulators the required in formats, degree of detail, and frequency. Investment banks will also need to establish communication channels with trade repositories in order to furnish required information in a timely manner. For this reason, firms may need to take urgent steps to overhaul their data management approach. Today, many firms have a silo-based approach to data management which requires data to be aggregated at the product or region level. This causes difficulties for risk management, reporting, and collateral management. A data management approach which supports the collection, aggregation, and analysis of data at a legal entity level is essential to meeting regulatory requirements.

Additionally, investment banks should take steps to upgrade trading infrastructure to meet the new regulatory requirements. Trading systems should track investments and trigger warnings when nearing limits prescribed by regulators. To comply with the provisions around proprietary trading, firms should verify that client trades have proper designations and records for future reference.

## 5. Conclusion

In conclusion, it can be said that regulations that have evolved in the aftermath of the financial crisis are here to stay. It would be in the best interest of investment banks to start taking urgent steps towards coping with the impact that the evolving regulations and their provisions will have.

No aspect of the investment bank's business can be expected to remain untouched by the regulations which have been evolving during the past few years. The revenue-generating potential will be curtailed, cost structure will be constrained, and the return on equity of business lines, especially the structured credit businesses, will be negatively impacted. Required recovery and resolution plans, enhanced reporting requirements, limits on executive compensation, stringent governance standards, and constraints on clearing, trading, and structuring of derivatives will put tremendous stress on the existing processes, operations, and business model of investment banks.

In this whitepaper we have discussed steps that investment banks may take to address the impact of evolving regulations: perform a viability analysis of different business lines based on capital requirement considerations; take steps to mitigate the impact of CVA charges; overhaul the collateral management system; aggressively manage costs and automate processes; upgrade the trading system; and prioritize efficient data management.

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