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The Tantalus Torments

How the regulator's crusade on Wall Street should seed investments to the real sector

In the Greek mythology, the gods punished their once patronized king of Phrygia, Tantalus, for his unthankful pride and sent him down to Tartar for eternal torments. The torments though were quite special in their ancient sophistication even for that dedicated place. As the starving king was reaching for fruit, the trees lifted their branches not leaving him a chance, and his thirstiness remained endless as well, because the lower he bent down to water, the more it drained.

In the modern industrialized world depressed by crises of overproduction, we find the same striking patterns of the ancient doom. Yet, the role-play is different.

The First Crusade: Extinguishing Fire with Oil

The state axed into the mess on financial markets in 2008 and ultimately took responsibility of the private sector for its accumulated debt off the banks' balance sheets. By an array of actions at the regulatory level, it re-filled the banks' depleted capital, and it did so in exchange for the bankers' commitment to stay away from lousy deals. But who needs a bank without a purpose? As we all know from the school years, a bank's ultimate purpose is to give loans to individuals and their businesses. Six years from then, the damaged economies worldwide are still in a crying need for fresh money. However, once burned by milk, creditors blow on cold water. The financial industry quickly sensed which way the wind blew, and made risk scrutiny their totem. No wonder the money they got from the state remained firmly stuck in their Treasuries. Like the poor Tantalus in the old times, the modern real sector starves for new cash, while that cash has been all around the place, yet not available to it. Isn't it the Phrygian curse, for the God's sakes?
According to the International Monetary Fund, the US Federal Reserve, and various economists, quantitative easing undertaken since the global financial crisis of 2007–08 has mitigated "some of the economic problems". It did not heal them though, and did not even address some of them.
From our perspective, if the idea behind the emergency expansionary measures undertaken by central banks was to have banks back to the lending business, it was doomed from the beginning.
The banks have been losing their lending expertise. Instead of digging deep into the borrower's closets for hidden skeletons, they opted for easier ways to get their lent money back. Forget about project financing, it's all gone, along with the bank's original risk-taking approach. They would ask you for a good collateral to start discussing an LTV that you probably won't like at all. Regretfully, the real sector is simply out of "good" collaterals! Because if they had them, there would be no reason for a QE. Well, the banks have another word for you, and that word is "securitization". Instead of syndicating a loan, which is still hard to get rid of if they would want to, they take you to the markets. Of course if the markets like you coming there. There is nothing wrong with this fee-based business, unless it replaces direct lending. Remember that only a fraction of borrowers, their more established part, is welcome to the markets. The problem that we see there is when a bank's cost-awareness couples with risk-aversion, it usually results in a gross loss of commitment. Why keep an expensive team of credit specialists in-house, when there are rating agencies around that would tick their box for a fee, and a bunch of investors eager to have a bite of a pie that is just half-baked? Mind you, many half-baked pies have come to the markets this way lately. When a bank loses its original risk-taking function and becomes a lombard with a very formal approach, when a lender is not committed to a borrower, an

entrepreneur loses faith in the financing system, no wonder it all falls apart. No wonder that the QE waves that kept coming like a tsunami ended up just in inflated securities prices. Here is what we have – a pile of money that is invested in a bit of everything, and having no proper understanding or a commintment to anything in particular. The public debt markets have turned into a "kickstarter" where you don't really mind giving an extra dollar for something that glitters at a distance but what you have no way of knowing in detail. Let's face it, you don't really care. How can we not have a mess here again?

We must pay tribute to the regulators, they realize that problem. They know that the quantitative breather to the financial sector has missed the target - the economy underneath it is still starving. Shh.. it looks like they have another ace up their sleeves.

The Second Crusade – Back To The Boot Camps

The financial regulation has always been critical to the market health, aiming at their stability, sustainability and the resulting contribution to the real economy. Markets have always felt suspicious of the oncoming regulations because they are naturally used to operating in the previous regulatory environment. Markets live in motion, but in a way, they do not like changes. The lasting global financial crisis has revealed the tough reality - regulator needs further and more substantial intervention. At this stage, markets have reached the critical point when the supervisory bodies have firmly stepped on the path of building up a severe regulatory environment.

The recent and forthcoming regulations and reforms drive the market participants into the tightest frames ever, imposing ongoing heightened control. Such regulations will impose restrictions on diversity of financial activities and limit the loopholes. That would have it collateral damage – many markets professionals will have to quit. Decrease of the number of market players and their stricter obedience should simplify global market system, according to the supervisors. We would argue that the whole financial system will be affected by those populist alterations, resulting in a less competitive environment and ugly liquidity. Those of you who actively traded a decade ago – ask yourself if the markets were liquid then, or they are now? Then compare the total market sizes. The result is tricky to comprehend – the much more sizable market now is a way less liquid than before. The reason is simple – there are few markets makers out there still willing to quote. This state of affairs would have surged the costs of borrowing on the markets, if there was no QE on time.

Yet, the policymakers want more sacrifice.

Basel III and CRD IV

The extensive changes assuming higher sustainability on the one hand, have produced some side effects, on the other. The introduction of Basel III (and CRD IV) aiming at the banks' stability and resistance to shocks has made the banks face new restrictions on asset quality and required more capital. The efforts of banking institutions to meet those lifted standards bring them to their limits and makes them focus on their core products only, give up on new projects and cut costs further.

Another barometer is pointing to accumulation of storm clouds too – the repo markets also suffer from the new rules, which are setting the limit on the capital for the banks' repo positions, causing cutback in liquidity not only on those markets, but also across all capital markets overall.

The lockup of cash results in a lack of options to invest, which is shrinking the liquidity in corporate bonds, in emerging and developed markets.

MiFID II and EMIR

The coming regulations are aimed at the market infrastructure improvement and more transparency. The mitigation of risks is to be achieved by means of introduction of central counterparties model (CCP) (set up in the EMIR). Those CCPs will be involved by intermediating the trades (mostly with the derivatives) between buyers and sellers. This innovation is to limit the operating risks. Such model is supposed to also provide the regulatory control over the transactions, change the risk management approach, and prevent market trade-related losses of counterparties, who would face the CCPs.

MiFID II introduces pre- and post-trade transparency by widening the list of the financial instruments and activities regulated within the EU. All these factors will have a substantial impact on non-equity instruments, especially derivatives and bonds. One of the means by which MiFID II is planning to achieve the desired transparency is implementation of various trading venues (OTFs – in service for non-equities) making the OTC markets functioning similar to 'on-exchange'. This shift to the trading venues will lead to decrease in the variety of possible business models, resulting in unifications of business activities.

Additionally the MiFID ruling is to oblige the market makers to quote the both sides of the financial instruments that will be classified as 'liquid'. But recently the policymakers haven't determined the proper classification applicable to bonds, while the definitions that have been made are the blind shots. Such imposed obligations may lead to wider bid-offer spreads, and even thinner markets in some securities, as they are now. Moreover this will result in higher operational costs, financial costs and costs of placing trade orders. That will finally end in inefficiencies of the market making capacity and have yet another essential impact on liquidity.

SSR, BRRD, CSDR

The separation of market-making activity has seemed a proper way to go to limit the speculations, support money inflow to the real economy sectors. The Volcker Rule in the US is already in place prohibiting proprietary trading for banks. Following this ruling it has been proposed to implement similar regulations separating market-making activity within the EU. Such introductions will obviously lead to fewer market-makers and less market-maker capacity ending in reduced efficiency, higher funding and capital costs and higher cost of debt.

Another rule in the process of adoption in the EU that is likely to contribute to the liquidity drop is the Short Selling Regulation, which has been supposed to add transparency to the sovereign debt and equity trades, bring stability to the markets. This ruling imposes the limit on the short positions for some instruments making the participants open only 'covered' short positions. This may re-focus the attention and drive the interested parties to alternative instruments and markets off the European shores.

The Bank Recovery and Resolution Directive (BRRD) is setting the background for recovery of banking and financial institutions imposing the amount of loss absorbing capacity. This amount is to be determined on the basis of numerous factors (size, risk profile, etc.). All those requirements, together with the costs of complying with these rules will increase the funding costs of banks that will be passed to the end-users, moreover will diminish the number of activity, especially of market-making, so the market participants will be less exposed to the risks. These factors will also have an impact on liquidity.

Additionally, the Central Securities Depositories Regulation (CSDR) that is currently being introduced imposes a mandatory buy-in provision in cases when the instruments are not delivered in time. Various mechanisms would be set up to initiate the buy-in procedure on the fourth business days (might be extended to the seventh) of failing to deliver the securities. Such regulations (launching is planned in the early 2016) will have a massive impact on market-makers, as they are not obliged to hold a position in the instruments they are quoting. These introductions will have significant influence on liquidity and bid-offers spreads too. The study published by ICMA estimating these regulations to lead to doubling of the bid-offer speeds even in most liquid sovereign bonds, while the secondary markets in some illiquid corporate bonds may fully disappear. Moreover all those provisions will make the investors and issuers face much higher costs.

The tax authorities also keep pace with changing the environment and adopt changes in the financial sphere. A number of countries have already taken actions to raise the taxation receipts by means of various novelties like the notorious Financial Transactions Tax, UK financial tax (the "Robin Hood" tax), etc. All those aspects would also enlarge the costs of all market operations.

There is no chance that the attempts to build a more stable and a stress-resistant banking system would have no negative consequences. Of course, individual influence of the regulations would not be remarkable, but the joint impact of numerous reforms would be hard to forecast and measure now. Altogether, the forthcoming introductions will make the market face the following issues:

- Drop of market-making efficiency.
- Shrinking and unification of banking activity.
- Deleveraging of banking institutions.
- Increase of costs.
- Limit in alternative business development models.
- Drop in liquidity on repo markets

Finis Sanctificat Media (Latin: "the purpose serves the goal")

Given the scope of the weapons used by the regulators in this current crusade, and the intensity of their use, we revert to the metaphor at the beginning of this story and make our unpretentious conclusion.

By introducing various frames and anchors for the mandatory use by the market professionals in this very part of the economic cycle, the regulators effectively lift the cost of using the markets, or, bluntly, make bankers re-consider their reasons of just being there.

They do so because they want those costs to be in line with what it takes a bank to become a lender again. They do so for this one reason – to make King Tantalus happy again.