INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT

Vol. 119

The Challenges Faced by Financial Institutions in European and Global Capital Markets

HIGHLIGHTS:

Limited scope to raise equity capital to repair bank balance sheets, and relatively weak business conditions and earnings, have handicapped the lending operations of European banks. The proposed Capital Markets Union (CMU) needs to make more progress to provide an alternative source of funds for the banking system and corporate sector in Europe. The higher Basel III capital and liquidity requirements have constrained bank market-making, evident most recently in the sudden collapse in the Italian bond market.

Significant internal restructuring at the European investment banks is underway, both horizontal unbundling related to jettisoning businesses, and vertical unbundling through increased outsourcing; Bank merger and acquisition activity is limited by lack of progress on the banking union initiative, with Europe left with a fragmented banking regulation.

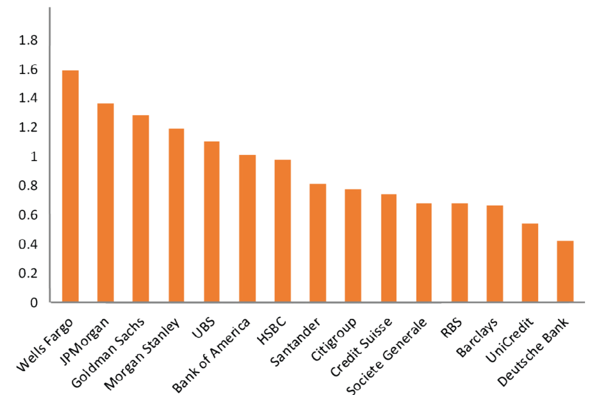
The EU regulatory priorities in fixed income markets include the introduction of new financial benchmark rates, both in the London and EU markets, to replace LIBOR, post-implementation assessment of MiFID III, and systemic implications of large asset managers.

An article that appeared in the June 14 edition of the Wall Street Journal commented on the widening gap in market capitalization, relatively low price-earnings multiples, and weak earnings performance of European global investment banks compared with U.S. banks. All the major investment banks in the U.S. and European markets were adversely impacted by the 2008-09 financial crash, resulting in severely weakened balance sheets and requiring substantial government bailouts to continue operations and provide credit to the underlying global economy. The U.S. banks were hit particularly hard, with the bankruptcies of Bear Stearns and Lehman Brothers, and extensive consolidation across the banking system, as the large surviving banks integrated Wachovia, Washington Mutual, Merrill Lynch and numerous other institutions into their operations.

The U.S. banks moved quickly in the aftermath of the financial crisis to raise equity capital to strengthen balance sheets and write-down poorly performing assets, taking full advantage of well-functioning and receptive domestic equity markets. The U.S. banks also benefited from recovering capital markets and economy. In contrast, the European banks did not have similar access to equity capital, nor the benefit of a recovering economy, and were handicapped by the restrictive regulations preventing a vigorous restructuring of operations. The sustained weakness in the European banking system, stemming from the inability to repair balance sheets and restructure operations, has come back to haunt economic recovery across Europe, given that bank financing is the predominant source of funding for most investment in Europe.

The presentations and panel sessions at the International Capital Market Association (ICMA) AGM and Conference in May this year addressed the policy and regulatory challenges for market participants, the business trends underpinning the banking system and capital markets in Europe and elsewhere, and the outlook for improving conditions and structural adjustments in the marketplace.

Global Bank's Price-to-Book Ratios
On 2017 Estimated Assets



Source: FactSet

REGULATORY PRIORITIES IN THE EU

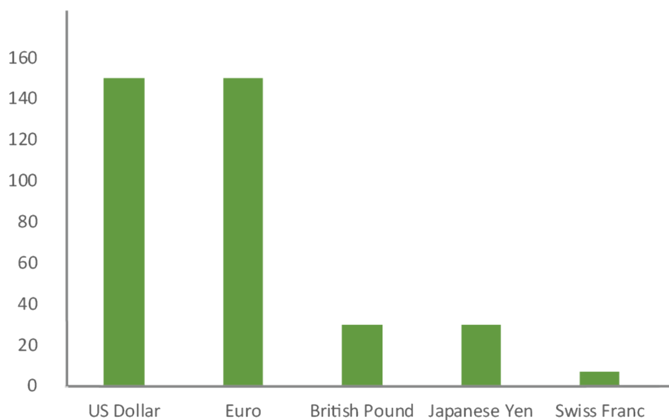
The immediate focus at the Conference was the reform agenda in Europe, led by the EU and European Securities Market Authority (ESMA). The banking industry has just completed implementation of the MiFID II rule framework, aimed at improving transparency and reporting obligations of dealers in the capital markets. The consensus is that, at least in the short run, the implementation process has gone smoothly, with much less market disruption than expected. For example, the transparency requirements in debt markets, after consultation, were calibrated carefully to avoid unintended consequences for market-makers. Some market participants think it is too early to measure the full impact of the MiFID II rules, and indeed the Basel III capital and liquidity rules. The sudden collapse in the Italian bond market in late May 2018 was a reminder of

the relatively thin veneer of liquidity in European sovereign bond markets that can give way to market dislocations in the event of external shocks. The banks are viewed as less reliant participants or market-makers in secondary bond markets, focusing trading activity on more active benchmark bonds.

The panels and speakers also focused on the need to replace the LIBOR financial benchmark with a more liquid, market-observable, risk-free rate. The regulators are targeting elimination of the LIBOR rate by 2021, given its precarious liquidity as a global representative benchmark rate. The effective reference overnight rate for unsecured transactions in the UK Sterling market (SONIA) and the reference rate based upon trade-level data from various segments of the repo market (SOFR) in the U.S., are the newly defined benchmark rates.

The first challenge of the exercise is to build out benchmark rates with extended term, and the second challenge is to re-paper the existing LIBOR-based contracts. The project is a daunting exercise, with approximately $370 trillion worth of contracts globally trading off LIBOR. Around $150 trillion in U.S. dollar-based derivatives and loans are based on LIBOR. The regulators will require dealers to play a key role in managing their client base to transition from LIBOR to the new benchmark rates. The resource requirements will be considerable. Canadian banks, insurance companies and other intermediaries and asset managers will similarly have to transition LIBOR-based contracts to the new financial benchmarks. Canada will continue with the CDOR and CORRA benchmark rates, but has initiated a project to examine the merits of a third liquid risk-free benchmark rate for the Canadian dollar marketplace.

LIBOR-Based Financial Contracts ($ Trillion)
By Currency



Source: J.P. Morgan Asset Management

COMPETITIVE PRESSURES

Tough competitive conditions in global institutional and retail markets have reduced commissions and fees across trading, retail wealth and asset management operations, and, together with rising operating costs from an increased regulatory burden and expanding technology applications, have tightened margins and weakened profitability. The general consensus is for modest improvement in business conditions and institutional performance as the global and European economies gather momentum, and as rates rise incrementally and spreads widen.

The elephant in the room is the competitive impact of FinTech, both adapting technology for conventional businesses, and the heightened competition from new entrants. Numerous observers see financial technology as having a transformative impact on the traditional financial businesses, particularly with market penetration driven by the large global platforms of Apple, Google and Facebook, and the large Chinese counterparts Alibaba and Tencent. The dramatic inroads of the Chinese tech companies in the financial markets in Mainland China has been nothing short of transformative, as these companies moved aggressively into the payment system, borrowing and lending, and asset management.

The access to massive personal data through their internet and media operations has enabled these firms to leverage their financial businesses. Despite firms benefitting from a more compliant and accommodative regulatory regime in China, the advantages of more competitive markets, more efficient and cost-effective operations, and greater consumer convenience for delivery of financial services has not gone unnoticed. There was discussion at the ICMA Conference that the regulatory system needs to adjust to a technology-driven marketplace. The approach must shift from entity or institutional focus to a focus based on market activity, notably risks and volatility. It was observed that, as regulators begin to re-think the paradigm, there is a notable lack of global coordination. The American tech giants will follow in much the same direction as the Chinese tech firms, but at a more moderate pace reflecting regulatory and systemic concerns. There was limited discussion of distributed ledger technology (DLT or block-chain) at the conference. However, Conference participants referred to imminent application of DLT in post-trade clearing, notably in private placement markets and stock exchanges, such as the Australian Securities Exchange (ASX).

RESTRUCTURING OPERATIONS OF THE GLOBAL BANKS

The Conference devoted time to the ongoing restructuring of the global investment banks in response to competitive pressures and squeezed margins. The recent efforts at restructuring business operations has been given particular emphasis at the European banks, mainly reflecting the weaker European economy and high proportion of under-performing balance sheet assets. The thinking on restructuring has two distinct strands: horizontal unbundling of operations and vertical unbundling. Horizontal unbundling is the shedding of certain under-performing businesses and related concentration of resources on core operations. For example, it is expected that Deutsche Bank will sell or wind-up its U.S. investment banking operations. We have already seen the Swiss banks initiate similar consolidation of operations into core businesses several years ago.

The vertical unbundling is the jettisoning of certain back-office or ancillary operations, relying on third party out-sourcing of these services and functions. One of the keys for success is sufficient scale in these ancillary and back-office operations to justify the outsourcing option. The ongoing Deutsche Bank restructuring has

shown that achieving effective cost-control can be a difficult and complex proposition.

It is important, as well, to recognise the construct of the European market itself has made it difficult for European banks to undertake strategic adjustments to strengthen earnings performance and balance sheets. For example, the EU has made little progress in its capital markets union (CMU) initiative to improve the depth and diversity of European equity markets, particularly to facilitate increased capital equity raising. In particular, the EU has made modest headway on developing securitization standards to enable the flotation of asset-backed securities, a vehicle to strengthen balance sheets and provide bank funding. Indeed, the outcome of the Brexit negotiations may make it even more difficult for European institutions to access the London markets for equity capital.

Second, the EU has made limited progress in achieving a banking union across Europe, moving to a single regulator, a single deposit insurance scheme and deposit protection fund, and uniform rules and regulations across the EU. This fragmented regulatory framework in Europe has made it difficult to access cross-border banking mergers, takeovers and joint ventures. For example, the merger between Société Générale and Unicredit proposed several years ago eventually came to nothing, given the complexities and effective barriers dealing with different regulators and different regulations.

CONCLUSION

For this first time the ICMA Conference panel sessions and speakers placed the focus on institutional and structural adjustments in the marketplace. Developments and trends in the capital markets and ongoing regulatory reform remained still key topics for discussion, but financial institutions, impacted by the squeeze in operating margins and reduced business from weaker markets in Europe, as well as extensive regulatory reform, are being forced to reconfigure operations in various ways. Resources are increasingly directed to operations that have a competitive advantage, particularly retail wealth operations and asset management, and making selective decisions on outsourcing to manage back-office operations. The difficulty consolidating banking operations, given a fragmented legal and regulatory framework, and the limited ability to launch equity offerings leaves these banks with limited options to restructure operations.

Yours sincerely,

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July 2018