FINANCIAL TIMES
FRIDAY JANUARY 3 2014

FT.COM | Trading Room

Comment: Regulatory predictions for 2014

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Last year we offered our 13 regulatory reform predictions for 2013 and correctly predicted a year of intense rulemaking. This was highlighted by the adoption of final Volcker rule regulations, Basel III capital rules and swaps market reforms. Careful scrutiny and implementation of these rules are expected to be key themes of the financial regulatory landscape in the coming 12 months.

1. Volcker compliance efforts dominate

Three years after the passage of the Dodd-Frank Act, market participants received a final set of Volcker rule regulations on December 10.

Amid the nearly 1,000-page release, one thing is already clear – Volcker regulations require a comprehensive compliance regime that, while tiered by size of financial institution, is nevertheless more onerous than expected. Banks will spend much of the year analysing their activities in light of the final regulations and building compliance infrastructures.

2. The five regulatory agencies determine how to jointly solve unintended consequences

The Volcker rule regulations are bound to have unintended consequences. The first was discovered quickly and painfully when many banks were forced to mark-to-market certain underwater collateralised debt obligations, backed by trust preferred securities in light of the requirement to divest them prior to maturity. Other unintended consequences are sure to follow. Solving these problems will be particularly difficult for Volcker, as five regulators will need to agree on the answers to any significant interpretative questions.

3. A deluge of banking regulations

In the first quarter we expect the US Federal Reserve to issue final rules to implement the enhanced prudential standards for systemically-important US bank holding companies and non-bank financial companies. These may include heightened risk-based and leverage capital requirements, liquidity standards, single counterparty credit exposure limits, enhanced risk management standards and an early remediation framework. We also expect the Fed to adopt its proposal to apply enhanced prudential standards to the US operations of foreign banks, and US banking regulators to impose on the largest US banking organisations Basel III leverage ratios that exceed those agreed upon by the Basel Committee. All of this will happen amid careful watch of the beginning of the regime of Janet Yellen as the new head of the Fed.

4. Swap market participants watch Timothy Massad

The controversial chairmanship of Gary Gensler at the Commodity Futures Trading Commission has come to an end. Little is known about the views of his likely successor, Timothy Massad, though more is likely to be revealed through the confirmation process. Mr Massad's first actions as CFTC chairman will be carefully scrutinised as market participants look for clues on whether he will follow Mr Gensler's aggressive path.

5. Mandatory Swap Execution Facility trading leads to short-term decreased liquidity

As we predicted last year, the implementation of the CFTC's swap market rules – perhaps the leading edge of regulatory reform – started to change swap market structure in 2013. The transition to mandatory clearing for certain interest rate and index credit default swaps went quite smoothly, but mandatory Swap Execution Facility registration did not.

Complications arose despite the fact that trading on Sefs (as opposed to the registration of Sefs), will not be required until February or March. We expect that transition to be messy, leading to decreased liquidity, at least in the short term.

6. The SEC requires registration of security-based swap market participants

In contrast to the CFTC, the SEC completed virtually no new rules for the new security-based swap regime last year. We expect this to change, with the SEC adopting many security-based swap market rules and requiring the registration of the first security-based swap dealers and major swap participants.

7. Banks to consider significant changes to organisation and trading structure

The rapid pace of regulatory reform and the less-than-optimal sequencing of final rules has forced banks to implement requirements in a piecemeal fashion. As the pace of rulemaking begins to slow, we expect banks to assess the interaction between, for example, the Volcker rule, capital rules and swap market reforms. Banks will need to make difficult decisions about their organisation and structure; those banks that make informed and careful decisions will probably achieve a comparative advantage for years to come.

8. Foreign banks with limited US presence consider abandoning US branches and subsidiaries

The significant compliance costs and the broad reach of the Volcker rule – which applies to all global operations of any banking entity with a US branch or subsidiary – will encourage foreign banks with limited US presences to reconsider whether having a US branch or subsidiary is worth the cost.

9. Foreign regulators push for further assessments of comparability

As foreign jurisdictions continue to adopt regulations that are consistent with the G20 commitments, foreign regulators will press the US to further recognise non-US regulations as comparable to those in the US and to permit market participants to satisfy their US law requirements through compliance with foreign law.

10. The Fed continues its focus on shadow banking

The Fed will probably propose measures to address risks related to short-term wholesale funding, including securities borrowing, securities lending, repos and reverse-repos that regulated financial institutions enter into with shadow banking entities. Measures may include minimum margin requirements as well as additional liquidity and capital requirements for the largest and most internationally active banking organisations.

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