NOT JUST A CHALLENGE FOR BANKS

WHAT WILL THE BASEL III LIQUIDITY COVERAGE RATIO MEAN FOR CORPORATES? SUZANNE JANSE VAN RENSBURG EXPLAINS

One of the challenges facing corporates in recent years has been keeping up with the accelerating pace of regulatory change. Numerous initiatives designed to stabilise the global financial system, the transparency and accuracy of financial information, and the efficiency of payments, have directly affected companies and required significant investment in order to achieve compliance.

Now the banking system is undergoing major change, with the introduction of the liquidity coverage ratio (LCR) under Basel III in January 2015. To date, few corporates have made preparations for its introduction because there is a widespread assumption that it only affects banks. While Basel III does not apply directly to corporates, however, it will have some implications for them, and therefore they should prepare for upcoming change.

Why Basel III matters

Banks have always held a liquidity buffer – funds specifically dedicated to cover outflows of cash that may be withdrawn in a crisis – to maintain stability during turbulent conditions. But the financial crisis showed that this buffer was, in some cases, insufficient. Now, a component of new banking regulation Basel III – the LCR – crystallises and, in many cases, could significantly increase banks' liquidity buffers. (For more, see Basel III: the details box, on page 35.)

The LCR is important for corporates because, as a result, banks will value deposits differently because they will be required to hold high-quality liquid assets (HQLAs) against assumed outflows in the first 30 days of a stress scenario. The higher the outflow assumption, the higher the HQLAs banks will have to hold.

For example, for every $100m of corporate deposits that are linked to the day-to-day working capital requirements of a corporate or financial institution, a bank will have to hold $25m in HQLAs on its balance sheet. The requirement to hold HQLAs increases the cost of doing certain types of business to such an extent that these costs may be passed on to banks' clients in one form or another. Most importantly, the LCR assigns different HQLA requirements to different types of deposits and clients. Banks are already changing their business models and pricing, and focusing on deposit types with low HQLA requirements and the products and services associated with them.

Crucially, application of the LCR framework represents a major break with past experiences since it relates to bank deposits: corporates used to expect a higher rate of return for excess balances than for their day-to-day working capital. Typically, working capital balances sit in non-interest-bearing demand deposit accounts. Corporates often maintain excess cash in a mix of non-interest- and interest-bearing deposit accounts, however. Because working capital cash (referred to as 'operational deposits' in the Basel III framework) will be assigned lower outflow rates under the LCR, those balances will become more attractive to banks. Conversely, excess (or non-operational) deposits on banks' balance sheets – depending on the tenor, terms and industry – could require banks to hold up to 100% HQLAs, thus signalling a potential change in pricing.

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Taking action

Corporates can prepare for the changes that will result from the introduction of the LCR since the new regulatory framework ultimately changes the way they should view their cash. In order to optimise cash, corporates will need to become more effective at segmenting day-to-day operational flows from excess or investable cash.

Efforts to improve visibility and control of cash have been

at the top of corporates' agenda for years now. Difficulties in obtaining access to liquidity when the financial markets were in an unsettled state increased the importance of internally generated cash (which is usually the most economical form of funding), and spurred efforts to enhance payables, receivables and inventory management. The LCR is certain to drive further efforts to improve efficiency, however.

For working capital management to become more efficient, corporates must improve their visibility and control of cash. Specifically, cash flow forecasting disciplines may need to be made more robust so that corporates know that cash will be where they need it at any given time. Improved knowledge of the whereabouts of cash, and more accurate predictions of when it will be required, will enable companies to centralise and consolidate cash using automatic liquidity structures.

Most importantly, greater visibility of cash makes it easier to segregate cash into working capital requirements, reserve and strategic categories. While Basel III may mean that banks will no longer be able to offer attractive returns for certain types of deposits not linked to the day–to-day working capital flows that sit on a bank's balance sheet, other off-balance sheet investment options, such as money market funds, are readily available. By allocating cash into the right liquidity bucket, organisations will be able to use these options to manage their liquidity more effectively and achieve their yield expectations while operating within the bounds of their investment policy framework.

A deeper relationship between banks and their customers

Corporates have long been accustomed to a certain level of scrutiny, whether for compliance with anti-money laundering or Office of Foreign Assets Control sanctions. But with the introduction of LCR, banks will need to spend even more time understanding transaction-level detail as a result of the increased information that regulators will require. At the same time, banks will need to help corporates adapt to the changes that will result from the introduction of the LCR. Banks are positioned to do this, since they are already immersed in developing methodologies and investing in pricing models and other technology to determine the impact of the LCR on their own balance sheets. This resulting expertise can help corporates adjust to the changing value of their day-to-day working capital deposits and their excess deposits currently sitting on banks' balance sheets. Basel III will undoubtedly result in deeper relationships between companies and their banking providers, since it will be more important than ever for banks to understand their clients' objectives.

It is essential that corporates clearly recognise the effects of the LCR well ahead of its introduction in January 2015. Organisations must put in place appropriate working capital management structures and cash flow forecasting models. Necessarily, these are long-term decisions that may require significant investment and are not to be taken lightly. Moreover, some changes may require board approval and should therefore be addressed imminently to ensure readiness for the introduction of Basel III at the beginning of next year.

BASEL III: THE DETAILS

Basel III, the latest version of the Bank for International Settlements' guidance on global regulatory standards, was developed in response to the experience of some banks during the financial crisis, which – while having adequate capital – failed due to a lack of liquidity. In contrast to previous versions of the Basel accord, Basel III addresses both liquidity and capital. Specifically, Basel III requires financial institutions to have access to sufficient liquidity to cover their short-term liabilities should a stress event occur. Liquidity is addressed by two main measures: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

In the EU, Basel III is being transposed into national law through the Capital Requirements Regulation (CRR) and the Capital Requirements Directive IV. The LCR, which is dealt with by the CRR (which acts as a single rule book to ensure uniform application of Basel III across the EU), will be implemented from January 2015, with 60% compliance in the first year, ramping to 100% by 2019. In the US, regulators have published their proposals for the implementation of LCR through a Notice of Proposed Rulemaking. It has a 2015-2017 time frame, with 80% compliance in 2015. The NSFR will be introduced from January 2018 onwards.

The LCR requires banks to hold different levels of high-quality liquid assets (HQLAs) based on run-off assumptions for different types of short-term liabilities (which are primarily deposits). HQLAs are tightly defined, but are generally assets that can be easily and immediately converted into cash at little or no loss of value. They cannot be used for other purposes. The levels of required HQLAs vary according to whether deposits are operational or non-operational, and whether they come from corporates or financial institutions (with further distinctions made between different types of financial institutions). The run-off assumption estimates the percentage of the liability (the deposit) that can be expected to be withdrawn from the bank by clients in the first 30 days of a stress event. For example, corporate operational deposits have a run-off assumption of 25% and a 25% HQLA requirement (the most favourable level). Corporate non-operational deposits have a 40% run-off assumption and HQLA requirement, while certain financial institutions could have significantly higher HQLAs for both types of deposits.

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