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Basel III
Changing the Rules of the Game for Corporate Treasurers

Spring 2015 Update

The full force of financial services regulation is about to come crashing down onto the desks of corporate treasurers. One of the potentially most disruptive regulations, Basel III, is right around the corner. Be prepared.

When "they" change the rules of the game, it usually changes the winners and losers. Add the three-point shot to basketball, and different players become the top NBA draft choices. Add or take away a tariff, and an import or export market suddenly prospers or dies. New rules can completely change what works.

Basel III Changes the Rules

"They" are changing the rules of banking with Basel III, imposing a new capital "tariff," which will impact borrowers, depositors and service users of all major banks. Many corporate treasurers regard Basel III as an obscure banking matter. Yet, Basel III could have significant corporate impact. Banks are changing their deposit strategies to comply with the new regulations, and are judging corporate clients by different standards. Depending on the nature of what you buy and the services you use, they may not place the same value on your business as they have in the past. Some banks have already begun turning away certain deposits and even whole relationships based on the new regulations.

Properly structured and presented, your business could be more valuable to your banks. Leaving it to chance could render your business less valuable. What you learn and do now may help you influence that.

The Details—How You Are Affected

Among other things, Basel III brings tighter regulation to the liability side of a bank's balance sheet, putting a premium on stable deposits. Important new ratios, such as the "Liquidity Coverage Ratio" will be applied to determine required liquidity levels. Required liquidity will soon be linked to the quality of a bank's liabilities, which will certainly affect credit availability, appetite for deposits, and pricing for certain services. This is likely to change banks' financial strategies and cause them to introduce new incentives for the relationships and deposits that help their ratios, and new disincentives for those that hurt.

The final liquidity rule was released by the U.S. regulators in late 2014, and banks are working to phase in the new requirements on a tight timeframe. The regulators have allowed for a transition period, but banks are already expected to be in significant compliance during 2015, with full compliance by January 2017. The banks are investing in substantial system overhauls and strategy reviews to ensure they meet the ratios they need and attract the "right" customers.

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Historical Perspectives Turned Upside Down

Corporate treasurers have historically valued banks for the liquidity banks can provide. Soon, banks will value corporate treasuries for the kind of liquidity corporates can provide. Treasuries have historically looked to banks for stability, places they can move money into or out of at a moment's notice. Soon, banks will look at corporations according to how much they add to or take away from the bank's funding stability. The new "Liquidity Coverage Ratio" essentially measures a bank's liquidity by breaking down two aspects of the balance sheet: the liquidity of the assets and the volatility of the liabilities. From the bank's perspective, companies that consume stabilizing products and services, and that provide stabilizing deposits, will be more highly sought after. Those with destabilizing products, services, and balances will almost surely pay a higher price—if they are banked at all.

Until now, corporate banking relationships have been carefully constructed around coinciding sweet spots, where the products and services most important to treasury are the products and services their banks are most interested in providing. Basel III essentially alters a bank's sweet spot. Banks will continue to look for ways to earn the highest return on capital, but the roads to get there will be different, and will probably vary from bank to bank. The changes will be so profound that some companies may have to look outside of banks for services, funding or cash investing.

The type of deposit a bank used to covet may now be an unwelcome burden. One can imagine many cases in which a bank would no longer accept volatile deposits. Instead, banks will court particularly stable depositors. Firms paying with compensating balances may become more attractive.

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The key will be in defining an "operational" deposit versus a "nonoperational" deposit. For a bank, operational deposits represent the stabilizing products and services that are provided. These will be the target deposits for banks, and will provide the most value to the institution. A nonoperational deposit is less valuable to a bank given limited flexibility the bank has to deploy these funds.

Many companies still have traditionally allocated their banking services based on functionality. For example, they have one group of banks for collection services, another group for disbursements and payroll and yet another for concentration and investments. In effect, this practice may take a very stable stream of cash flows and disaggregate it into smaller, more volatile streams. That, in turn, could make the company's business less attractive and profitable to banks who are now concerned about meeting liquidity coverage and net stable deposit ratios.

New banking structures will be required; virtually every company will need to change major parts of its transaction business to get there. A new banking structure will be more easily justified as an operational deposit to the banking regulators than a former siloed structure, and therefore more valuable to the bank. If a bank can't prove a deposit is operational, it may be assessed a higher internal capital charge, becoming unprofitable to offer. The corporate customers using those products will have to find substitutes.

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The Banks Respond

A recent Treasury Strategies survey asked banks basic questions about their Basel III response teams. We found that banks have migrated from interpretation of the new guidelines to implementation and strategic initiatives to better position their balance sheet for compliance. Banks have begun segmenting their portfolios to focus on increasing operational deposits and decreasing or eliminating unprofitable deposits. And while the banks have begun evolving to comply with the new regulations, there are more changes to come.

What's a Corporate Treasurer To Do?

What we conclude from this survey is that it's time to restart the mating rituals and open serious conversations with your banks—and perhaps with banks that haven't been your banks. And, while there is a final ruling, banks are taking different approaches to how they internally define an operational deposit. This is why it will be crucial to talk to your current bank and competitor banks to understand what they're looking for in a deposit portfolio; the kinds of services, balance levels, and volatility levels that will qualify as an attractive deposit. Banks will focus their attention on retaining and growing attractive deposits, while shedding unprofitable relationships.

For corporate treasurers, the stakes are very high. Commercial banks, for many, are the primary sources of credit; that will change for some firms. Commercial banks are the primary repositories of corporate cash, and that will also change for some firms. Commercial banks are the primary providers of transaction and payment services. That too will undergo disruption.

The key to corporate treasury success is to be proactive. Know your bank. You must begin to understand all the subtle ways in which your company can be more or less attractive to your banks. The answer will likely differ by bank, depending on the bank's asset and liability composition and the nature of its funding.

Just as anti-money laundering and then anti-terrorism finance created a mandate for banks to "know your customer," there should now be a mandate in the corporate treasury world to "know your bank."

Armed with new information about relationship value drivers for each of your banks, you can intelligently consider how to restructure bank credit and services networks. A smart treasurer will realign and reallocate services in a win-win for the company and its banks. A treasurer who lags will almost certainly have higher operating service pricing and less attractive interest rates, and may even find themselves turned away at the door.

The key to corporate treasury success is to be proactive.

We're Here to Help

If you're having a difficult time with any of your initiatives, or if you'd like help thinking through your treasury strategy, call us. It's in our name – Treasury Strategies! We can help. With the correct methodology and approach, together we can make 2015 your best year ever!

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