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DEALING WITH HIDDEN PROVISIONS OF NEW FINANCIAL REGULATION

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For some time, treasurers have been anticipating regulatory reform and wondering how it will affect, among other things, their profits, risk, investments, bank relationships and global growth plans. The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act created a small measure of clarity, but many of the details are yet to be determined.

As a result of Dodd-Frank, 10 different regulatory agencies are now developing approximately 500 new rules required by the law. To provide some perspective on how massive that is, the Sarbanes Oxley Act of 2002 required just 16 new rules — and it had financial and accounting executives working long hours for several years to achieve compliance.

The following analysis of Dodd-Frank and other new global regulations identifies 13 measures that can directly affect a corporate treasury.

There are three words that best summarize these measures: *Massive*, *intrusive* and *global*.

- **Massive.** The regulations cover all aspects of the financial markets and alter the flow of capital.
- **Intrusive.** The breadth and depth of the new rules will effectively trigger a complete reorganization of business practices and will demand treasury to focus on more compliance, more reporting and prescriptive risk mitigation.
- **Global.** Jurisdictions throughout the world will have to tighten regulatory requirements.

Taken together, these changes create tremendous uncertainty in the financial markets. The costs of capital, credit and transaction services will all rise as these regulations and their consequences — both intended and unintended — filter through the marketplace.

TREASURY

THOUGH MANY OF THE RULES FOR THE DODD-FRANK ACT ARE YET TO BE WRITTEN, DEEP INSIDE ITS 2,300 PAGES ARE MANY HINTS OF WHAT'S TO COME. ELIMINATE SURPRISES BY KNOWING WHAT'S AHEAD IN ORDER TO TAKE ADVANTAGE OF NEW OPPORTUNITIES.

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BY LOOKING A LITTLE CLOSER TO THE DETAILS, A FEW CLEAR AND CONSISTENT IMPACTS FOR CORPORATE TREASURY ARE APPARENT: RELATIONSHIPS ARE CHANGING, COSTS ARE RISING AND OPTIONS ARE DIMINISHING.

Treasurers are acutely aware of the handful of regulations that will directly impact their businesses. However, it's important to stay aware of all areas of regulatory change and be prepared for those that could potentially impact treasury. Like an alligator in a swamp, any one of these regulations could jump up and attack an unsuspecting treasury organization. Each of the 13 areas listed below could potentially impact corporate treasury:

INTEREST ON BUSINESS CHECKING

The repeal of Regulation Q now allows banks to pay interest on business checking accounts, over-the-counter derivatives and consumer revolving credit.

This change sounds good for corporations, which can now earn interest, as well as banks, which can differentiate competitively. However, there are issues that need to be resolved.

Business deposits are responsible for 80 percent of commercial banking profits. Banks are concerned about maintaining margins in the new operating environment, which has completely upended the profitability economics of their business. Additionally, banks face higher costs to offer these services, and those costs will undoubtedly be passed on to corporate clients.

For corporations, Federal Deposit Insurance Corp. insurance will not be available on interest-bearing accounts. Thus, it is necessary to assess counterparty risk, as well as safety versus risk tolerance in the portfolio mix. Investment policies and procedures will also need to be updated, and the value of various processes, such as concentration, will have to be assessed.

UNLIMITED DEPOSIT INSURANCE

Corporations have an opportunity to take advantage of the unlimited deposit insurance for noninterest-bearing corporate direct deposits in the bank.

The Federal Reserve and FDIC have given banks the opportunity to opt out of this program, but almost all of the 8,000 United States banks are remaining. Only a handful of the largest banks are opting out, possibly because they believe they can raise deposits without this insurance support. Banks must pay premiums for this insurance, which will create higher service fees and more complex earned credit rate structures.

FEES ON DAYLIGHT OVERDRAFTS

The Federal Reserve now requires daylight overdrafts to be collateralized or it will charge the bank a 50 basis-point fee.

This change is most likely to impact firms with significant financial flows and timing differences in funding disbursements with late-day monies and/or transfers. Banks are likely to change how they handle overdraft capacity for corporate customers.

For example, it's possible they might delay a wire payment in order to avoid an overdraft. Alternatively, it's possible the banks might offer wire products with bifurcated pricing:

- Bifurcated option 1 — send the wire immediately with a higher fee;
- Bifurcated option 2 — send the wire sometime today at the normal fee.

SAME DAY AUTOMATED CLEARING HOUSE SETTLEMENT

The Fed is moving to same day ACH settlement. Debits will occur a day earlier and will impact cash flow. It's time to start reexamining cash forecasts to ensure that ACH debits occurring so much faster won't negatively impact balance sheets.

MONEY MARKET FUND REGULATIONS

Recent regulations require money funds to invest in instruments with shorter maturities and limit the amount of commercial paper they can hold.

Taken together, these changes mean lower yield for investors because the investments are shorter. They also mean reduced access to credit for private sector borrowers because of limitations on commercial paper in favor of government securities holdings.

Additional Critical Regulatory Issues

The remaining eight items are also important to watch and prepare for their potential impact, no matter how great or small their perceived threat.

OTC DERIVATIVES

The crisis revealed a lot of risk hidden in the so-called shadow system of hedge funds and derivatives. These trades are now forced into clearinghouses and exchanges. Dealers and other parties to these transactions must post capital and meet margin requirements.

It's still unclear whether end-user trades are exempted. End-user trades would cover most kinds of corporate risk hedging transactions. So this is an issue treasurers should watch closely.

If end-user trades are not exempted, posting margin for treasury type transactions would require an estimated $770 billion of additional collateral — a huge amount of liquidity that would have to be extracted from corporate coffers and the financial systems.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

Given that IFRS is an issue that's been discussed for several years, it's likely already on the radar screen for many companies. Benefits of migrating to IFRS would mostly apply to large corporations that, under IFRS, would gain from having a single set of standards for reporting purposes.

Although largely an accounting issue, it is important for treasury to understand the differences between generally accepted accounting principles and IFRS and where treasury is impacted. Treasurers should stay on top of the transition requirements, at least enough to understand when a treasury-related transition may be on the docket, as well as the costs of switching to IFRS.

BASEL II AND III

The Basel Committee on Banking Supervision is considering requiring higher capital requirements and more risk measures for financial institutions worldwide. The objective is to reduce the leverage of these institutions and thereby reduce their risks.

Unfortunately, when the leverage of the institution is reduced, the institution's ability to lend money is impacted, restricting access to capital.

The Basel Commission is also interested in requiring banks to extend the maturity of their funding. This could lead to a restriction in lending capacity because of reduced leverage and higher costs.

EUROPEAN BANK STRESS TESTS

As with the Basel issue, the European Bank Stress Tests dealt with the adequacy of bank capital. The purpose was to reassure the market about the health of the financial sector in Europe. While the tests were criticized as not tough enough and lacking transparency, they did give analysts information assessing the banks' quality and eliminated some uncertainty in the market.

UNITED KINGDOM LIQUIDITY ADEQUACY STANDARDS (FINANCIAL SERVICES AUTHORITY)

FSA has issued a requirement for financial institutions to maintain liquidity buffers, essentially requiring banks to invest part of their portfolio in very short-term maturities — overnight to seven days. The rule also restricts their investments to government securities for that specific liquidity buffer.

As a result, the move toward investing short and investing in government securities is further crowding out private sector borrowers.

INTEREST ON BANK RESERVES

Since the Fed began paying interest on the reserves banks leave there, reserve levels have risen dramatically. In fact, before the Fed announced this program, reserve levels were $45 billion and very rapidly rose to $1 trillion.

This crowding out of the private sector means $1 trillion in potential borrowing capacity, or supply, has been removed from the liquidity system. That money is no longer available for corporate lending — difficult to understand since the government continues to encourage banks and corporates to "get that spending going."

TERM DEPOSIT FACILITIES

Related to paying interest on reserves held at the Fed, a term deposit facility has the Fed bidding higher rates on term deposits. In effect, the Fed is selling certificates of deposits to banks. Sold at auction, there is no limit on the rate the Fed can pay. Couple that with the guarantee of the U.S. government, and once again we see a crowding out of the private sector.

CONSUMER REVOLVING CREDIT

Depending on a corporation's situation, treasury may be impacted by consumer-related credit issues. There are new restrictions on consumer revolving credit as well as reporting and disclosure requirements that can affect an organization's treasury.

Value of a Prepared Treasurer

The regulations outlined above are massive, intrusive and global in nature. By looking a little closer to the details, a few clear and consistent impacts for corporate treasury are apparent: Relationships are changing, costs are rising and options are diminishing.

Corporate treasury has already become a more strategic asset to the organization due to increased awareness as well as pressure from boards and chief financial officers following the financial crisis. The changing regulatory landscape is a huge challenge, but a prepared treasury can maintain its strategic position.

It's imperative to take proactive steps to build internal tools that can monitor the regulatory landscape, assess potential regulatory impact and help to come through the regulatory chaos unscathed.

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