Analysing the Dodd-Frank Effect on Corporates

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The repeal of Regulation Q as a result of the Dodd-Frank law means banks will be allowed to pay interest on business chequing accounts for the first time since the 1930s. Corporates need to take steps to prepare for the inevitable shifts in the marketplace.

While banks are the primary target of the Dodd-Frank law, the impact on corporate treasurers will be almost as massive. As banks adjust to the new regulations, they will pass along higher costs to their corporate customers. The repeal of Regulation Q, a remnant of 1933's Glass Steagall Act, will be one more factor as both banks and treasurers navigate change. What can corporate treasurers expect from the repeal of Regulation Q?

Bank Services Repricing due to Changing Profitability Economics

About 80% of commercial banking profits are derived from business deposits, so banks are concerned about maintaining margins as they comply with the directives of Dodd-Frank.

Attracting a base of funds and maximising profit are the key drivers behind business deposit strategies for banks. Demand for loans, closely related to the state of the overall economy at any given time, will be an important factor in driving demand for deposits.

- Commercial banks will face a higher cost of funds as they begin paying interest. Higher cost of funds along with higher deposit insurance premiums may be recouped through higher fees on transaction services. Also, there will be increased scrutiny of low-margin relationships due to lower cross-subsidisation of unprofitable fee relationships by deposit spread.
- Banks' competitive position in the market may be strengthened, especially versus fund companies, as banks can offer a safer vehicle - unlimited FDIC insurance on non-interest bearing accounts - or compete against funds via rates through interest on business chequing.

The broad sweep of Dodd-Frank threatens to fundamentally change the profitability economics of commercial banking, unravelling a complex, interconnected system developed over 80 years since the Great Depression. Against this backdrop of change, banks' strategies for responding to the repeal of Regulation Q will not evolve in a vacuum.

With the repeal of Regulation Q, banks must re-evaluate their business models and pricing structures. Their challenge is to carefully calibrate rate structures and transaction fees so they attract a customer mix that optimises their return on capital.

Bank Responses

To identify possible directions that banks may decide to take, Treasury Strategies spoke with bank clients from 12 of the largest US banks. They indicated several potential responses being considered.

One key point is that banks expect to compete with operating services, not rates. They recognise that competing solely on interest rates would erode the value of demand deposit accounts.

One option under consideration is a hybrid product that would incorporate an earnings credit rate on balances until service fees are paid. Then interest would be paid on excess balances. At that point, corporate treasurers might find it more attractive to leave more cash in bank accounts as 100% of their funds would be put to productive use.

Corporates Can Prepare Now

A corporate's investment policies, instrument mix, counterparty risk management and bank relationship management strategies are just a few areas that will be directly impacted by the repeal of Regulation Q.

Right now, treasurers can take the steps outlined below to prepare for the upcoming shifts in banking practices.

Leverage banking relationships
Treasurers should contact their banks to discuss their plans related to Regulation Q changes. Banks may be open to discussions, and there may be an opportunity to negotiate higher interest rates if additional cash remains on deposit. Regardless of the final interest or fee compensation model adopted by the corporation, Treasurers will need to factor these new economic dynamics into their strategies for managing banking relationships and allocating their cash management fee business to their relationship banks.

Assess options and financial return
While it is too early to work with solid numbers, it is possible to model an optimal portfolio. By examining various rate scenarios, treasurers can determine how to rebalance their deposit portfolios in light of new deposit products and rate structures. Treasurers should prepare now to consider the extent to which hybrid or interest-bearing accounts may be attractive, as well as to evaluate whether funds currently held outside of bank deposits should be moved into deposits.

Review the collection channel
For many corporations, such as retailers or restaurants with collection points that number in the thousands, the usual strategy is to centralise cash as quickly as possible, then use the cash to pay down debt.

As banks begin paying interest on business chequing, the new source of interest revenue could mean a narrower spread between bank chequing returns and those of other short-term investments. Companies could choose to leave money on deposit since their returns are higher. In that case, the rationale for zero balance accounts and other cash concentration products would become less compelling.

Another factor to consider would be interest revenue versus expenses, that is, the costs of rapid cash consolidation.

Be aware of potential counterparty risk
As banks use interest-paying deposits as an incentive to consolidate cash, and treasurers take steps to consolidate deposits, this change could result in additional counterparty risk.

Watch changes from fund companies
Facing their own set of new regulations and increased competition from banks, fund companies will look for ways to attract cash. In response to bank competition, fund companies are likely to point out that higher banking service charges can more than offset gains from interest paid. We may also see fund companies introduce new products to compete more effectively with banks. Depending on a firm's demand for liquidity and underlying maturity of its cash portfolio, these new funds - such as ultra-short fixed income funds - may pose an attractive option.

Opportunity Ahead?

Dodd-Frank has created an intricate, interrelated set of regulations with massive, intrusive and global implications. It also adds a new layer of complexity to the role of a corporate treasurer, which has already been made more demanding as a result of the financial crisis.

Despite these challenges, there are steps you can take now to prepare:

- Leverage banking relationships.
- Build financial models.
- Review collection channels.
- Monitor potential counterparty risk.
- Watch for changes from the fund companies.

Bank account structures, increased revenue from yield, counterparty risk, instrument mix… new opportunities and threats abound with the repeal of Regulation Q. Corporate treasury departments must strike the right balance in order to capitalise. And opportunity will only favour the prepared.

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