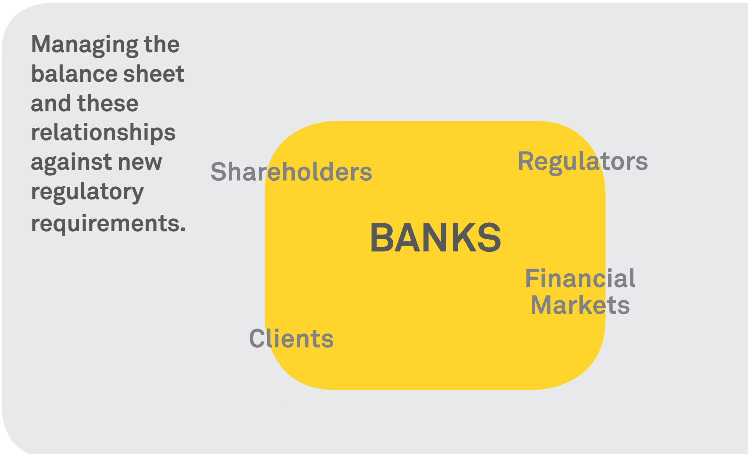
The Impact of New Banking Regulations on Corporate Relationships – Looking from the Inside Out

Regulators worldwide are working to reduce risk in the financial markets, and banks are at the center of these efforts. Using the lessons learned during the 2008 financial crisis, regulators are instituting measures to help ensure that banks have sufficient capital and liquidity to cover loan losses and cash outflows in the event of another market tailspin. The new regulations aim directly at the heart of a banking institution, its balance sheet, and banks now have the challenge of managing their balance sheet in line with these new regulatory guidelines.

As banks work on managing their priorities, there will be a ripple effect from the new regulations into the corporate treasurer's office which will redefine its banking relationships. Corporate treasurers will have to manage cash, finance operations and follow through on the company's business goals in this new environment.

The Challenge for Banks



A Bank's Balance Sheet — Under a Microscope

A bank's balance sheet provides a rough sketch of its client relationships, including its relationships with corporate clients. On the asset side of the balance sheet are loans — from large, term loans for companies making acquisitions, to revolving credit facilities that are drawn upon, to credit lines covering custody activity or letters of credit. A corporation's cash deposits sit on the liability side of the bank's balance sheet, held by the bank overnight or longer term as corporate treasurers seek safety and returns or need to keep cash at the bank to be used as collateral or to cover, for example, custody transactions. By targeting the balance sheet, new regulations will create a unique balancing act in which banks seek to build and maintain these elements of corporate client relationships while trying to meet regulatory requirements and earn sufficient income on their assets to create value for their investors.

The New Regulatory Requirements

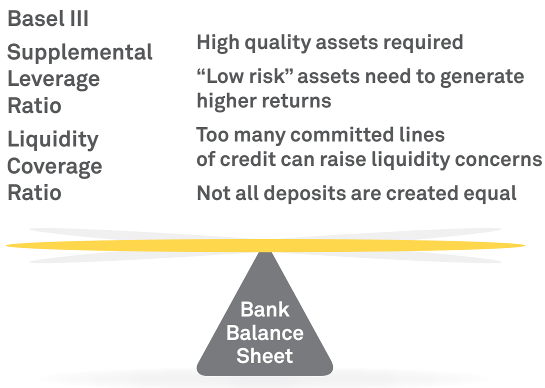
Two new regulatory requirements aimed at the banking industry, but ultimately affecting corporate banking relationships, are the Supplementary Leverage Ratio (SLR) and the Liquidity Coverage Ratio (LCR). Both introduced by the Basel Committee on Banking Supervision (BCBS), these ratios will have an impact on a bank's decision to take on assets (i.e., loans) and manage liabilities (i.e., cash deposits).

The Supplementary Leverage Ratio — All Loans are Created Equal

The SLR, scheduled to take full effect in 2018, is calculated as follows.

$$\text{Supplementary Leverage Ratio} = \frac{\text{Tier 1 Capital}}{\text{Total Leverage Exposure} \atop \textit{(on- and some off-balance sheet)}}$$

Banks need to achieve a certain SLR (3%, 5% or 6% depending on the institution) in order to fulfill regulatory requirements, and this SLR measures the capital "cushion" that can cover the bank's leverage if loans go into default and lose value. This leverage includes both items on the bank's balance sheet as well as some off-balance sheet items such as unfunded credit commitments. However, unlike other bank capital ratios, the SLR does not consider the risk-weighting of assets anywhere in the calculation. Capital, at the most basic level, is calculated as the difference between a bank's assets and liabilities. All of the assets used to calculate the bank's capital in the SLR (again — think loans) are treated equally and carry the same weight. So for the purpose of the SLR, a bank with mostly AAA loan commitments has to set aside the same amount of capital as a bank with mostly BBB loans, all other factors being equal. Meanwhile AAA commitment fees are lower than those for BBB loans, so the capital behind the AAA loan commitments is earning less income.



As a banking institution looks to achieve its mandated SLR and deploy its capital profitably, where does that leave its corporate banking relationships? One potential outcome is a change in a bank's lending pattern. If all loans require the same amount of capital to be set aside, then less profitable lending facilities will undergo more intense scrutiny. Fewer banks may join a corporate credit syndicate where there is limited return, or when reviewing a loan request, the bank will have to assess the entire relationship and balance profitability against the services/credit facilities provided. This is not entirely new as banks always had to consider return on risk-adjusted capital (RORAC). However, for some institutions, the new non-risk based analysis will be more onerous.

The Liquidity Coverage Ratio — But not all Cash is the Same

The LCR focuses on the risks on both the asset and liability sides of the bank's balance sheet during a 30-day period of financial stress.

$$\frac{\text{High Quality Liquid Assets}}{\text{Net Cash Outflows}} > 100\%$$

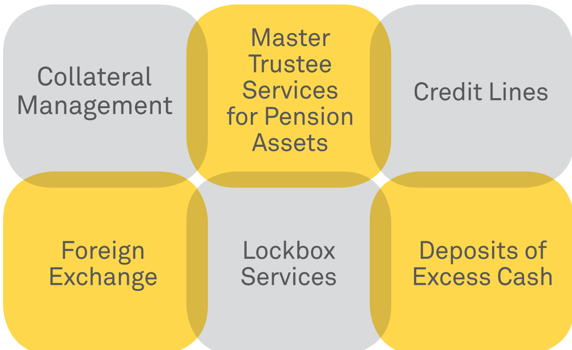
High Quality Liquid Assets (HQLAs) can include, but are not limited to, certain central bank deposits and treasuries. Net Cash Outflows are a combination of deposit run-offs and borrowers maximizing their loan commitments minus the receipt of loan payments. The scenario behind the LCR is a period of financial stress which causes draw downs on credit facilities at the same time as significant cash withdrawals from deposits. The LCR wants to help make sure that the bank has the "right type of cash" to meet loan commitments in this period of financial stress. Cash just sitting in an account and earning interest is easy to withdraw and will be the first out the door during a financial crisis. However, operational deposits, cash balances associated with custody transactions or lockbox services, are more difficult to withdraw, and it is these types of cash deposits that the LCR favors.

So, as banks try to manage the cash on their balance sheet in order to meet LCR requirements, corporate deposits will come under close scrutiny. Banks will have to continually assess their appetite for non-operational deposits, and corporate treasurers may have to look elsewhere. Placing cash in a money market fund has traditionally served as an alternative to holding cash with a bank, but impending money market reforms could affect that option as well. These reforms, which mostly affect Prime and Tax-Exempt funds, include floating NAVs and fees and gates to prevent investors from pulling their money out during times of stress (including economic stress as well as idiosyncratic stress that would affect a fund's liquidity). Corporate treasurers need to understand these reforms and whether money market funds continue to be a viable option for corporate cash.

With these New Ratios, How are Banks Looking at their Corporate Relationships?

Banks will continue to maintain, develop and value corporate relationships, but they may begin to review the entire relationship more strategically, taking into account

Corporate Banking Relationship



credit exposure, non-credit business and the impact of the relationship on key regulatory ratios. How will a credit commitment affect the bank's SLR? Does the client hold significant operational balances? As the bank works through these issues, one potential result may be fewer but stronger corporate banking relationships comprised of multiple products and significant ties in terms of people, technology and services. Another potential result involves cost. In particular, the SLR may increase the cost of credit, even on an undrawn commitment, and these costs will have to be borne somewhere in the financing ecosystem.

There's Still Time before the Regulations Take Effect

G-SIBs (global systemically important banks) will have to report the SLR in 2015, and the US version of the LCR will ramp up in 2015. However, full implementation of the new regulations is still a few years away, and each bank's strategy for dealing with these ratios will develop over time. The market may create new services to help banks deal with the balance sheet implications of these ratios. There may be consolidation in the industry, with fewer banks providing the financial services that corporations require. As banks work through these regulatory implications, what should corporate treasurers do to prepare for the future?

Are You Ready?
Checklist for Managing Your Relationships with Financial Service Providers

- ✓ Talk to your corporate lender and understand the bank's approach to these new ratios. What is being discussed as loan requests come in?
- ✓ Review your financial service providers. What other services can the provider offer to you? Are there potential benefits to linking up several services within one provider — efficiencies, lower fees, streamlined reporting, etc.?
- ✓ What specific areas of value do each of your relationship banks provide to your business? (What are those banks' key strengths?)
- ✓ What sources of funding/liquidity are available to your firm today, beyond typical bank borrowings?

From a financial institution's perspective, new regulations mean coming up with comprehensive, workable strategies for managing their balance sheet, profitability and corporate client relationships. Lending models may be affected, or overall business models may change. While this unfolds, corporate treasurers need to think long-term and become very directed and strategic with their relationships.

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