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.

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.

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

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.

Basel III
Supplemental
Leverage
Ratio
Liquidity
Coverage
Ratio

High quality assets required
"Low risk" assets need to generate
higher returns
Too many committed lines
of credit can raise liquidity concerns
Not all deposits are created equal

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.

\[
\text{High Quality Liquid Assets} \quad \text{Net Cash Outflows} \quad > \quad 100\%
\]

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 Lines
Collateral
Management
Master
Trustee
Services
for Pension
Assets
Foreign
Exchange
Lockbox
Services
Excess Cash

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.

David Cruikshank
Executive Vice President
Corporates and Public Finance
Market Segment
BNY Mellon

BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may also be used as a generic term to reference the Corporation as a whole and/or its various subsidiaries generally. Products and services may be provided under various brand names and in various countries by subsidiaries, affiliates, and joint ventures of The Bank of New York Mellon Corporation where authorized and regulated as required within each jurisdiction. Not all products and services are offered at all locations. The material contained in this article, which may be considered advertising, is for general information and reference purposes only and is not intended to provide or be construed as legal, tax, accounting, investment, financial or other professional advice on any matter, and is not to be used as such. The contents may not be comprehensive or up-to-date, and BNY Mellon will not be responsible for updating any information contained within this article. This article, and the statements contained herein, is not an offer or solicitation to buy or sell any products (including financial products) or services or to participate in any particular strategy mentioned and should not be construed as such. BNY Mellon recommends that professional consultation should be obtained before using any service offered by BNY Mellon. BNY Mellon assumes no liability whatsoever (direct or consequential or any other form of liability) for any action taken in reliance on the information contained in this article, or for resulting from use of this article, its content, or services. Any unauthorized use of material contained in this article is at the user’s own risk. Reproduction, distribution, republication and retransmission of material contained in this article is prohibited without the prior consent of BNY Mellon. © 2015 The Bank of New York Mellon Corporation. All rights reserved.