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Liquidity strategy
– new rules or new game?

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Following the 2008 financial crisis, financial markets are adjusting to a substantial shift in the regulatory landscape aimed at promoting greater stability in the banking system. As these initiatives phase in over the next few years, starting with key changes in 2015, implications will be far reaching – not least in the management of liquidity. The nature of the "liquidity relationship" is changing, presenting challenges and opportunities for treasurers to consider. This paper discusses the impact of Basel III liquidity ratios on treasury with cash to invest or manage, and the evolution of investment strategies in response to these changes.

As the financial system adjusts to the shift in the regulatory landscape understanding how this may impact pools of cash and investment policies has never been more important.

In general terms, Basel III, via the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) gives preferential treatment to deposits held on bank balance sheets that have an element of stability to them. So, all other things being equal, deposits that are operational in nature or for a longer fixed term are particularly attractive from a Basel III perspective. This is because a bank is required to place a portion of each deposit that falls into certain categories into High Quality Liquid Assets (HQLA) to meet regulatory liquidity ratios.
created equal.

Description of Basel III liquidity rules

Net Stable Funding Ratio

- To address the issues caused by many banks' over resilience on short term wholesale funding, regulators have introduced the Net Stable Funding Ratio (NSFR) as part of Basle III. NSFR requires banks to fund their assets with more stable sources of liquidity (in terms of tenor, type and sources of liability).
- A bank's Available Stable Funding (ASF) must be at least equal to their Required Stable Funding (RSF).

Liquidity Coverage Ratio

- The outflow table on the right shows the percentage of a bank's liabilities with <1M contractual maturity that would be assumed to flow out in a 30 day liquidity stress scenario. The bank is required to hold HQLA against this outflow.

Bank's Liabilities	Outflow
Retail and SME deposits	5-10%
Financial institution deposits	100%
Non-financial corporate deposits	40%
Operating Accounts	25%
Secured Funding with L1 collateral	0%

High Quality Liquid Assets

- A bank is required to hold HQLA against certain types of deposits to ensure they have adequate liquid assets that can readily be converted into cash in a 30 day liquidity stress scenario

Bank's Assets (HQLA)	Outflow
Cash and central bank reserves	0%
Government bonds	0%
Agencies	15%
Corp and covered bonds ≥ AA-	15%
Corp bonds A+ to BBB-	50%
Unencumbered equities	50%
Residential MBS ≥ AA	25%

As can been seen from the table above, the implication for treasury is that some types of deposit will simply become less economical for bank balance sheets to absorb – especially if not part of a broader relationship or set of deposit types. This will have a major impact of corporate liquidity strategies from two distinct angles: 1) understanding the type of cash being placed and its likely regulatory cost will be imperative, 2) developing an investment strategy that allows use of new or alternative products will likely be required.

The demand for High Quality Liquid Assets (HQLA) will increase as banks are required to increase holdings over time and the Money Fund Regulations in the U.S. increase demand from "Government Only" money funds. This could impact both the availability of these products to corporates as an investment tool and substantially reduce the yields, presenting challenges to expected returns on excess cash pools. We look at this in more detail in our paper "Investment policy, surgery required?"

Degrees of separation

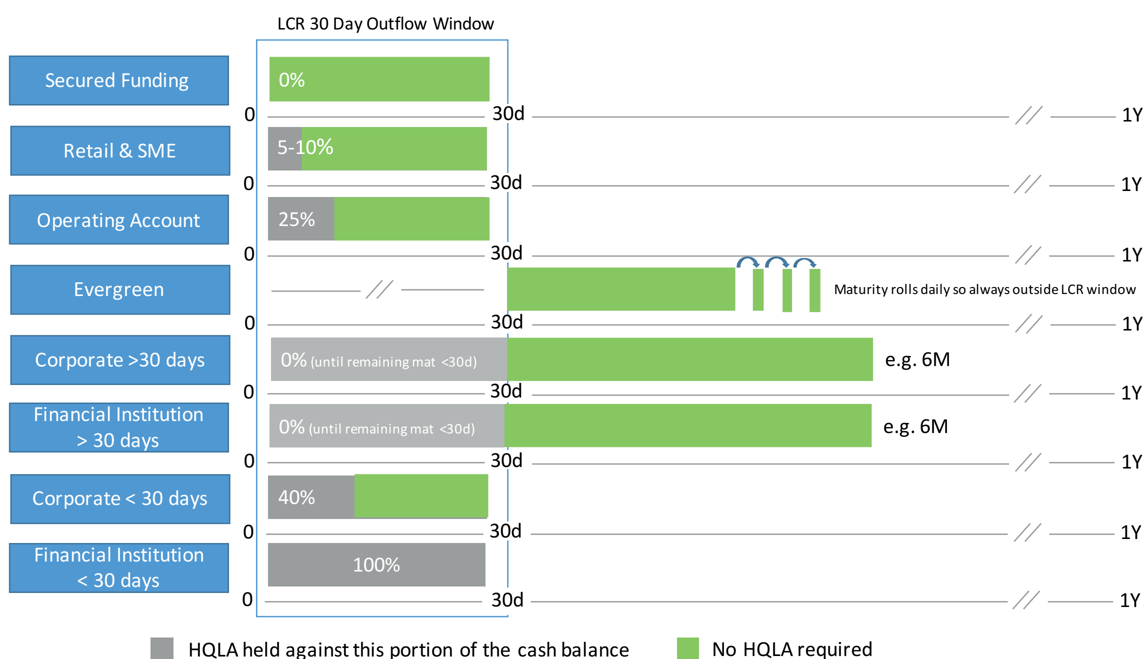
To help us review how liquidity value can vary, let is look at a worked example of how a bank might value different types of deposit from the same client, and then how it may vary by client type (see diagram below)

Basel III is being implemented over different timescales by local regulators and, in many cases, with some local adjustment to the rules. This means that there will be some differences in how banks apply these regulations and therefore the potential availability of investment products, and pricing, may vary by geography. This may also influence where treasurers choose to set up their regional treasury centres in future.

One outcome of this is that application of the rules may therefore be uneven and banks will be forced to focus their balance sheet capacity, both on the asset and liability side, only where deep client relationships exist. With this focus how deposits are placed will come into consideration when reviewing relationship value so balancing the needs or a corporate for term financing and short term cash placement will be looked at closely.

No going back to how it was

As we can see the necessity for banks to manage liquidity at an ever more granular level, as part of an overall relationship assessment, and the implied costs of doing so means that liquidity markets will evolve to a new game. Even when the interest rate cycle turns from the current historic lows, there is no going back to how it was as the drivers of liquidity value have changed, permanently.
As cash pools continue to grow one possible outcome is that treasury may be tasked with obtaining a benchmark return for surplus funds that have historically been kept in short dated products, particularly on cash that can be defined as strategic. There are a range of investment solutions available for this with can been aligned to the liquidity needs and risk policies of the business.



Increasingly variations of deposit products that include more optionality, for example evergreen, extendable, or two-way break options will be offered as part of a liquidity relationship. There may be some relative return benefits for the depositor in these products but understanding the risks from an investment and liquidity angle will be important.

Conclusion

The nature of the liquidity relationship is changing, driven by the substantial shift in the regulatory environment. New measures of the value of different types of cash, and new product features, require treasury to navigate the new rules, new game. It is a challenge that each company will likely approach differently dependant of the size and location of their cash balances. It will be increasingly important for treasury to build knowledge of the regulatory impact of each part of their banking relationships, and work with strong partners in the management of operating and excess cash.

About the author

David Castle is Managing Partner of Waltham Partners Ltd, a financial services consultancy. Formerly Global Head of Money Market and Financing Sales at Standard Chartered Bank where he spent 15 years in a number of senior positions in the group, including Head of Global Markets, UK/Europe, and the same role for the Americas. Prior to joining Standard Chartered, David worked at Citigroup in Money Markets and Fixed Income. With more than 25 years of financial markets experience, his expert knowledge spans a wide range of products including fixed income, treasury, asset-liability management. While based in the US he served on the NY FRB FX Committee, is IMC certified and a member of the UK CFA and ACI, and a Fellow of the Institute Of Directors.

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