How will Basel III impact cash management at trust companies?

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JCAP TREASURY SERVICES

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Background

One of the main lessons learned from the financial crisis of 2008/09 was that losses in the financial sector can be extremely large when a downturn is preceded by a period of excessive credit growth. Vulnerabilities were exposed in the regulation and supervision of the banking system as institutions entered the crisis with capital of insufficient quality and quantity and governments were forced to step in to provide unprecedented support to the banking sector in many countries. The existing framework of regulation for the financial sector (as defined by the Capital Requirement Directives (CRD) in Basel II) was identified as having a number of drawbacks namely capital that was non loss absorbing, failing liquidity management, inadequate group wide risk management and insufficient governance.

In April 2009 the global leaders of the G-20 nations agreed to commit to a new set of rules to strengthen the resilience of the financial sector to improve the quantity and quality of capital in the banking system, introduce a supplementary non-risk based measure to contain the build-up of leverage and to develop a framework for stronger liquidity buffers at financial institutions.

In December 2010, The Basel Committee issued detailed rules of new global regulatory standards on bank capital adequacy and liquidity that collectively are referred to as Basel III.

The new framework divides the current CRD (Capital Requirements Directive) into two legislative instruments: collectively known as CRD IV.

CRD IV consists of a Regulation (CRR), establishing the prudential requirements for individual institutions, and a Directive (CRD) governing the access to deposit taking activities. The CRR and CRD are complimentary and together establish the new banking regulatory framework that will eventually replace the existing Capital Requirements Directives.

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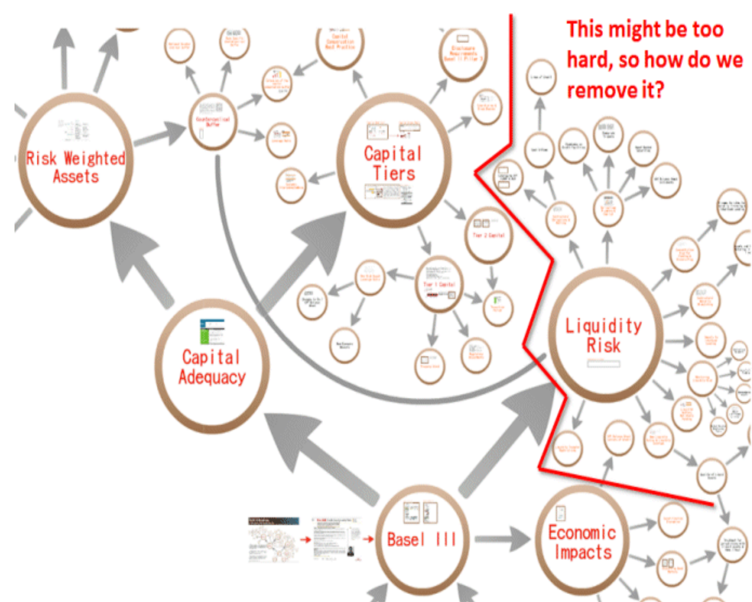
Purpose

The impact of Basel III's regulatory changes on deposit rates is a very broad and heavily discussed topic. The substance of this whitepaper concentrates on the implications of the implementation of Basel III on the rates that banks are likely to pay for cash and how this impacts on rates available to trust companies.

Our research has shown that most banks operate different funding models and it is unlikely, therefore, that every bank will behave in the same way when setting interest rates in the future. What is probable is that Basel III will have an impact on how banks treat client's cash. This paper goes on to explain the ways that trust companies can use active cash management to ensure that they preserve and enhance returns for their clients under the new rules.

Understanding the jargon



The Basel Committee: The Basel Committee on Banking Supervision is based at the headquarters of the Bank for International Settlements in Basel, Switzerland and has the task of developing minimum standards on bank capital adequacy.
Capital Requirements Directive (CRD): The current EU bank capital framework is represented by the Capital Requirements Directive and reflects the proposals of the Basel Committee. It must be implemented through national law.
Capital Requirement Regulation (CRR): The CRR-Regulation is directly applicable to anyone in the European Union and is not transposed into national law. It includes most of the technical provisions governing the prudential supervision of institutions.
CRD IV: CRD IV is made up of the Capital Requirements Regulation and the Capital Requirements Directive.
Regulatory Capital: Only capital that is at all times freely available to absorb losses qualifies as regulatory capital.
Capital Adequacy Requirement: The amount of capital an institution is required to hold compared to the amount of assets, to cover unexpected losses.
Liquidity Coverage Ratio (LCR): The LCR aims to ensure banks maintain adequate levels of unencumbered high quality assets against net cash outflows over a 30 day significant stress period.
High Quality Liquid Assets (HQLA): Assets which their liquidity generating capacity, through sale or secured borrowing, is assumed to remain stable even in periods of severe idiosyncratic and market stress, and should be easily and immediately converted to cash at little or no loss of value.
Net Stable Funding Ratio (NSFR): The proportion of long-term assets which are funded by long term, stable funding.
Net Cash Outflows: are total expected cash outflows minus total expected cash inflows.
Cash Inflows: are assets which are expected to continue to perform during the 30 day stress period.

Haircut: In finance, a haircut is a percentage that is subtracted from the market value of an asset that is being used as collateral. The size of the haircut reflects the perceived risk associated with holding the asset.

$$\text{Liquidity Coverage Ratio} = \frac{\text{High Quality Liquid Assets}}{\text{Net Cash Outflows for 30 Day Period}} \geq 100\%$$

$$\text{Net Stable Funding Ratio} = \frac{\text{Amount of Stable Funding}}{\text{Required Amount of Stable Funding}} \geq 100\%$$

Liquidity measures

One of the Basel Committee's key reforms to develop a more resilient banking sector is through the introduction of two new liquidity measures, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The first is a measure to ensure that a bank can survive a 30 day stress event and the second is to make sure that banks fund long term assets with a mix of deposits within their books. The LCR will have the biggest impact on how a bank manages its short term liquidity and therefore it is the effect of the LCR on short term deposits (defined as less than 30 days) that we examine in this paper.

The LCR measures the ratio of High Quality Liquid Assets such as cash or Government bonds by the total net outflows under a 30 day stress event.

Originally the Basel Commission dictated that the LCR will be introduced on 1 January 2015, with the minimum requirement to be set at 60% and rise in equal annual steps to reach 100% by 1 January 2019. This graduated approach was designed to ensure that the LCR can be introduced without material disruption to the orderly strengthening of banking systems or the ongoing financing of economic activity.

This time table was revised by the Basel Committee in January 2013, and a faster implementation schedule was proposed taking into account that the economy was far more stable in 2013 than it was in 2009. The Basel Committee now recommends that 100% LCR is now implemented by 1 January 2018 at the latest, however, many banks are planning to implement the 100% LCR requirement in a much shorter time frame.

Critically the introduction of the LCR will reduce the value of less than 30 day deposits at banks, as the regulators have dictated that only a certain percentage of these deposits will be considered eligible to meet banks funding requirements during a 30 day stress period. The weighting that is applied to the different types of deposits will vary according to the classification of the depositor.

The percentage by which a cash deposit's value is reduced depends on the definition of the depositor. Retail deposits and small or medium enterprise deposits (where total deposits do not exceed £1,000,000) will be subject to a 5% - 25% haircut, non-financial corporates and national or government entities will receive a 25% - 40% haircut, financial corporates a 25% - 100% haircut and banks a 100% haircut. The various weightings are governed by the regulators belief that certain deposits are more likely to be withdrawn during a stress event.

Funds that are held in trust company accounts have historically attracted higher rates as they have demonstrated stickiness. Whether the premium that these funds have historically received will be maintained after the implementation of Basel III is now subject to debate.

Perhaps the most important factor that needs to be considered is whether a trust company will fall under the definition of a financial customer, and if it does what percentage of reduction in value of its deposits will be applied by banks.

A Financial Customer

The definition of a 'financial customer' under the Basel III rules is governed by Article 410 of the CRR which states a financial customer is a customer that performs one or more of the following activities:

1. Taking deposits and other repayable funds.
2. Lending including, inter alia: consumer credit, credit agreements relating to immovable property, factoring, with or without recourse, financing of commercial transactions (including forfeiting).
3. Financial leasing.
4. Payment services.
5. Issuing and administering other means of payment (e.g. travellers' cheques and bankers' drafts) insofar as such activity is not covered by point 4.
6. Guarantees and commitments.
7. Trading for own account or for account of customers in any of the following:
    (a) money market instruments (cheques, bills, certificates of deposit, etc.);
    (b) foreign exchange;
    (c) financial futures and options;
    (d) exchange and interest-rate instruments;
    (e) transferable securities.
8. Participation in securities issues and the provision of services relating to such issues.
9. Advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings.
10. Money broking.
11. Portfolio management and advice.
12. Safekeeping and administration of securities.
13. Credit reference services.
14. Safe custody services.
15. Issuing electronic money

Or is one of the following:

- A credit institution
- An investment firm
- A securitisation special purpose entity
- A collective Investment Undertaking
- A non-open ended investment scheme
- An insurance undertaking

- A financial holding company or mixed financial holding company

Trust companies are not specifically listed in the above definitions and therefore, at this stage, it is not possible to state conclusively how they will be assessed.

At present there has not been any published guidance from the JFSC or GFSC as to whether trust companies will be defined as financial customers and so we currently have a situation where banks have no clear guidance.

JCAP have been informed by the JFSC that they are working together with their colleagues at the GFSC to assess the impact of the Basel III rules on financial services firms in both jurisdictions. It is possible that trust company balances will be regarded as corporate funds and not retail. The JFSC are currently working on a LCR consultation paper which will go out to the industry for discussion but it is unlikely that the findings will be published until Q3 2014.

The role of cash management

Irrespective of how banks treat trust company client's funds, funds that have a short dated duration will become less attractive for banks to hold and demand for funds with a maturity of over 30 days will increase. New products will be introduced by banks to compete for the longer dated funds. JCAP are already designing products with banks to both meet the needs of our clients and fulfil the balance sheet requirements of the banks.

One of the main results of the changing interest rate environment is that trust companies are realising they need to be even more pro-active in managing their underlying client's cash to ensure that the clients are positioned to benefit and not suffer from the changes.

JCAP have conducted a study of existing clients funds held in instant access accounts and the outcome shows that the perception that client's funds are needed to be always kept on instant access is not always the case. Often a percentage of these funds may be able to be tied up for longer durations. We have come across instances where cash has been kept on call for several years without ever being accessed.

With the current flat yield curve there has recently been little incentive to place funds on longer maturities as the rates for instant access funds are relatively high compared to longer rates.

The adoption of Basel III may result in the yield curve steepening as sub 30 day deposit rates fall and the demand for longer dated funds rises due to an increase in demand under Basel III and a natural steepening of the yield curve as the expectations of a base rate rise increase.

JCAP offers a simple solution to trust companies that recognises the need to spread a client's cash assets into different liquidity products in order to benefit from the higher rates available.

By creating a 'portfolio' of accounts in different parts of the yield curve the underlying customer will benefit from a blended rate for their funds that will significantly improve the return for funds that are left on call.

Trust companies underlying client's cash can either have their cash managed in a bespoke portfolio (if they have significant cash assets or if they do not qualify to have their funds pooled) or held in a pooled portfolio.

JCAP's specialist software allows for trust companies to operate multiple pools from a single designated account and so participants in pooled portfolios benefit from the higher rates available and the diversification of funds across several counterparties while the trust company benefits from not having to open multiple accounts for each client.

The software will be able to accurately identify which funds belong to each client in each pool with transparency and flexibility.

Summary

- Adoption of Basel III will have an impact on call rates and short term rates below 30 days
- Trust companies will become more pro-active in the management of client's cash
- Portfolios of pooled funds will provide an efficient cost effective solution balancing yield, liquidity management and diversification of funds

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