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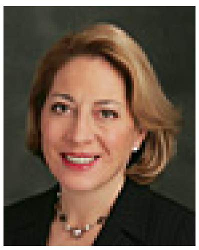
Banks and Corporates Can Work Together to Manage Liquidity, Address Basel III



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In response to new Basel III capital requirements, banks are starting to promote longer-dated deposit products — both existing and new ones — that offer a win-win opportunity for them and their corporate clients. These deposit products can help banks acquire more high-quality liquid assets to satisfy Basel III requirements, while enabling their clients to earn a higher rate of return than is typically offered on overnight deposits.

I, II and III

Basel III is the most recent of the Basel Accords forged by a group of central bankers known as the Basel Committee on Banking Supervision. The first Accord, known as Basel I, was published in Basel, Switzerland, in 1988 and was primarily focused on mitigating credit risk through minimum capital requirements. In 2004, Basel II introduced regulations to mitigate bank operational risk.

Spurred on by the late-2000s financial crisis, the Basel Committee reconvened to produce a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk in 2010. The Third Basel Accord is being phased in beginning this year, with some capital reserve requirements increasing over time until implementation concludes in 2019.

Basel III requires banks to show they can support their business and their positions during stressful times. Regulators want to be able to evaluate how quickly a bank's clients would withdraw their deposits under stress conditions.

To gauge the potential for deposit "runoff," regulators are requiring banks to report and meet standards for two liquidity risk ratios: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSF). Many banks have already begun reporting these ratios. Deutsche Bank, for instance, has started calculating its LCR.

Impact on Banks' Deposit Mix

To meet the LCR standard, banks must maintain sufficient liquid assets to cover net cash outflows under a 30-day stress scenario. Each dollar of assumed runoff requires an offsetting dollar of low-yielding, high-quality liquid assets.

Under Basel III, deposits needed for operational purposes are qualified as stable and have a more favorable risk weighting of 5% to 25%. All other balances are classified as less stable and have a risk weighting of 75% to 100%. (The risk-weighting percentage signals how much of the deposits would be expected to "run off" in times of stress.)

The risk weighting of deposits requires banks to rebalance their portfolios and segregate stable and non-stable or excess funds on dedicated accounts.

Banks are responding to Basel III's emphasis on holding higher-quality liquid assets by making existing term deposit products more attractive and offering some new deposit product options.

Corporate Implications

In the new regulatory environment created by Basel III, corporations can expect to experience greater rate variations on deposit products based on banks' different liquidity requirements and ratings. Return on overnight investments is likely to fall while longer-dated deposit products should provide an opportunity to increase returns.

In order to take full advantage of such opportunities, corporations will need to actively manage their short-to-medium term investments. Additionally, they will need to work to both minimize counterparty risk and increase the accuracy of their cash forecasting.

Liquidity Management Solutions That Can Help

As a result of Basel III, banks are finding overnight deposits less attractive and longer-dated deposits — such as 35-, 65- or 90-day term deposits — much more attractive. Accordingly, many banks are paying higher interest on these longer-dated deposits.

But basic term deposits aren't necessarily the best solution for banks, as such deposits start losing their LCR value as their maturity approaches. That's why banks like Deutsche Bank are beginning to offer another deposit product that has even more LCR value: a call deposit.

Call deposits have an agreed-upon notice period but no predefined maturity date. A 60- or 90-day call deposit has an infinite term until it is called. Thus, from an LCR perspective, it's a higher-quality asset than a time deposit with a finite term.

To take advantage of longer-dated deposit products such as term and call deposits, corporations need to practice effective cash forecasting to better assess the availability of their excess cash — and banks also offer products to help in this regard. For instance, Deutsche Bank's Liquidity Manager is a planning and execution application that helps companies monitor their cash and investment positions.

By using a tool like Liquidity Manager to improve cash forecasting, corporations can better position themselves to benefit from the more attractive interest rates that banks are offering on longer-dated deposit products.

As Basel III begins shaping the regulatory environment this year, liquidity management products like call deposits and Liquidity Manager are giving banks and their corporate clients an opportunity to work together to meet their separate but equally compelling goals.