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The Transformation of Corporate Deposits in a New Regulatory Environment

And Seven Tips to Cope with the New Reality

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Abstract

Bank deposits have always represented the main cash management vehicle for institutions. Growth in deposits and money market fund balances crisscrossed each other over recent decades. Recent financial regulations, notably the liquidity coverage ratio, net stable funding ratio and G-SIB capital surcharges, caused deposit dynamics to change, reducing banks' appetite for non-operating deposits. We offer seven practical tips to help treasury managers cope with the new deposit reality.

Seven Tips to Cope:

1. *Deepen existing relationships*
2. *Diversify*
3. *Size still matters*
4. *Integrated counterparty risk assessment*
5. *Liquidity is the name of the game*
6. *Alternative liquidity vehicles*
7. *Beware of higher interest rates*

Introduction

For centuries, businesses and individuals used banks for the majority of their financial transactions. The creation of the Federal Reserve System in 1913 and the Federal Deposit Insurance Corporation (FDIC) in 1933 gave the United States one of the strongest, safest and most trustworthy banking systems in the world. It is no surprise that treasury organizations rely heavily on deposits as their primary liquidity management vehicle.

The two decades before the U.S. financial market crisis of 2008 can be characterized as a period of rapid deregulation and disintermediation along with waves of bank mergers. The subsequent dramatic re-regulation to reduce systemic risk presents new challenges to corporate cash investors. On the one hand, transactional deposits become less profitable for large banks, which motivates the institutions to move them off balance sheet or impose stiff fees. On the other hand, institutional prime money market funds, a popular alternative cash vehicle, must adopt floating net asset values (NAVs) and optional redemption fees and gates by October 2016, limiting their utility as liquidity tools.

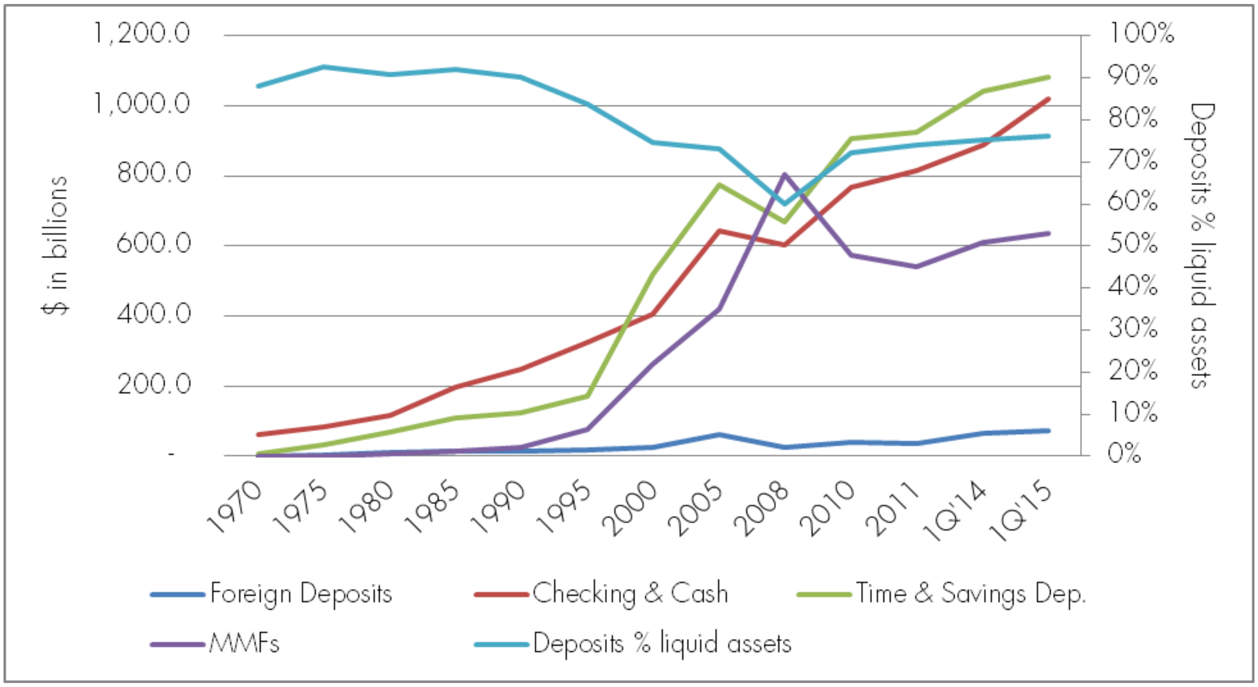
With these concerns in mind, we seek to help corporate treasury professionals to refocus attention on the mundane world of transactional deposit relationships, understand the current market dynamics, and carve out a balanced approached to cash investment solutions.

Corporate Deposits in Historical Perspective

Checking and savings deposit balances typically represent the majority of liquid balances at businesses and other institutional entities. In recent decades, the banking industry went through the dismantling of interstate banking restrictions and the re-integration of commercial and investment banking. Banks grew larger and more complex. Recent financial crises also produced shotgun marriages that resulted in still larger banking complexes. Sweeping post-crisis financial regulations under the umbrellas of the Basel III Accord and the Dodd-Frank Act added new dynamics to institutional deposit relationships.

Alternative liquidity vehicles, most notably money market funds, took on more important roles during the disintermediation period. Credit concerns with prime funds after the Lehman Brothers bankruptcy and subsequent unlimited government deposit guarantees caused the tide to turn back in favor of deposits. With the approach of the October 2016 deadline to float the NAVs and impose optional redemption fees and gates, expectation is growing that more assets will flow out of money market funds into deposits.

Figure 1: Deposit and Money Market Fund Balances at Nonfinancial Businesses



Source: Federal Reserve's Flow of Funds Report - Section L.101 Nonfinancial Businesses as of the first quarter of 2015.

According to the Federal Reserve's Flow of Funds reports (Figure 1), the proportion of deposits held by non-financial businesses as a percentage of overall liquid balances declined steadily from 92% in 1985 to 61% in 2008. Coincidentally, money market funds gained popularity since the mid-1990s, with balances surpassing checking balances at $780.0 billion in 2008 before a multi-year decline. Meanwhile, deposit balances reversed direction as a percentage of liquid balances in 2008 and reclaimed market share lost to money market funds.

Recent Deposit Growth Trend

The Fed's flow of funds report captures the three types of deposits held by nonfinancial businesses in the U.S.: checking & cash, time & savings deposits, and foreign deposits. In the decade through the first quarter of 2015, checking account balances in the U.S. grew 58%, or at a 5% annual compounded rate, compared to the 40%

growth, or 3% per annum, in time and savings account balances. Foreign deposits grew 16% growth, at 1% per year, over the same period.

As Figure 1 indicates, both checking and savings balances grew at the expense of money market fund balances, which dropped sharply after the financial crisis of 2008. Fund balances have resumed an upward trend since 2011. As an extraordinary measure shortly after the Lehman Brothers bankruptcy, the FDIC provided guarantees without the $250,000 limit on all noninterest bearing transaction accounts (NIBTAs, essentially all business checking accounts), through December 2012[1]. By contrast, the U.S. Treasury guaranteed a stable $1.00 NAV on money market funds balances through September 2009[2]. The time lapse between the two expiration dates may partially explain directional changes in funds movement.

Types of Deposits Available To Institutions

Checking: Also known as a transactional account or demand deposit account (DDA), the non-interest bearing checking account is the standard and most widely used deposit type and cash management vehicle available to businesses. Funds are available on demand without restrictions as to the number of checks or electronic funds transfers drawn on available funds. It comes with the FDIC deposit guarantee of $250,000 per taxpayer identification. The Dodd-Frank Act of 2010 repealed the prohibition of paying interest on DDAs, but the vast majority of business checking accounts continue to be non-interest bearing.

Savings and Money Market Deposit Accounts (MMDAs): As the name indicates, funds in savings accounts earn interest income but funds' availability may be delayed. Depositors may make up to six withdrawals in a statement cycle of one month. These restrictions diminish the utility of savings accounts as cash management vehicles. MMDAs are a variation of savings accounts that allow limited check writing privileges but total withdrawals are still limited to six per month.

Time Deposits (TDs): More widely known as certificate of deposits (CDs) in the U.S., time deposits are similar to savings accounts but generally earn higher interest income because depositors are committed to pre-determined dates of maturity. Access to funds before maturity may be unavailable or may incur early penalties, including principal losses set by law or the depository institution. Liquidity restrictions on TDs and CDs reduce their utility as cash management vehicles.

Offshore Sweep TDs: Popular with some money market funds and institutional depositors, a type of time deposit exists at some U.S. banks and U.S. branches of foreign banks. The depositor allows the bank to deposit (sweep) its excess balances to an affiliate branch in a foreign country (see Eurodollar TDs below), typically for an overnight period, before receiving it back the next morning. Functionally equivalent to interest bearing checking sweeps, offshore sweeps bear the credit risk of the foreign bank affiliated, cross-border financial transaction risk, and reduced supervision by U.S. financial regulators. Although funds are typically available overnight with comparatively attractive yield, offshore sweep TDs are not considered liquid funds.

Large Denomination CDs: Also known as jumbo CDs, negotiable CDs, or broker CDs, CDs with face values of $100,000 or more are sold to institutional depositors, often through securities brokers as marketable securities. Jumbo CDs may receive higher yield and may be more liquid than regular CDs as a secondary market exists to buy them before maturity. Market conditions and interest rate changes, though, may result in principal losses in jumbo CD transactions. Jumbo CDs do not receive FDIC deposit guarantee on principal above $250,000.

[1] See the FDIC's "Notice of Expiration: Temporary Unlimited Coverage for Noninterest-Bearing Transaction Accounts", https://www.fdic.gov/news/news/financial/2012/fil12045.html#cont

[2] See "Investor Alerts – Treasury Guarantee Program for Money Market Mutual Funds: What You Should Know" on FINRA's website https://www.finra.org/investors/alerts/treasurys-guarantee-program-money-market-mutual-funds-what-you-should-know

Banks also report deposit notes, issued to institutional investors in $1 million denominations with features similar to corporate bonds, as large denomination CDs.

Yankee CDs and Eurodollar TDs: They are subsets of large denomination CDs. Yankee CDs are issued by U.S. branches of foreign banks seeking to obtain funding from U.S. money market funds and other liquidity investors. Eurodollar TDs are dollar denominated TDs issued and held outside the U.S. Neither Yankee CDs nor Eurodollar TDs receive a FDIC deposit guarantee. Because the latter exists outside of the U.S., liquidity may be poor and credit risk higher for U.S. based depositors.

Liquidity Coverage Ratio and New Deposit Relationships

The term Liquidity Coverage Ratio (LCR) has received a lot of attention lately among institutional depositors, especially after JPMorgan, in response to LCR, sought to reduce $100 billion of non-operating deposits to save capital. This ratio could have wider ramifications on depositors at other banks.

The 2010 Basel III Accord introduced two liquidity standards for banks, the LCR and the net stable funding ratio (NSFR). In the U.S. the LCR rule came into effect on January 1, 2015. The NSFR is expected to be introduced in 2018. The LCR applies to bank holding companies with assets of more than $50 billion, although restrictions on banks with over $250 billion in assets are most severe.

In essence, the new rule requires banks to hold sufficient high quality liquidity assets (HQLAs) against potential run-offs of deposits in the next 30 days. Both assets and deposits are subject to calculation maneuvers of limits and haircuts to arrive at a required ratio of 100% or higher. On the deposits side, for example, 97% of retail deposits are expected to be retained, with 3% lost to run-offs in the next 30-days. Table 1 provides the run-off assumptions for wholesale deposits.

Table 1: Assumed Wholesale Deposit Run-offs for LCR Calculation (non-FDIC Insured)

Deposit Type	Assumed Run-off Rate
Operating Deposits	25%
Non-Operating Deposits – Non-Financial Depositor	40%
Financial Deposits (Operating or Non-operating)	100%

For a non-financial institutional depositor, this means that, for every dollar deposited, the bank must use 25 cents to purchase low yielding HQLAs, leaving only 75 cents towards more profitable lending activities. Should a deposit account be classified as non-operating, which generally means standalone deposits, the bank needs to keep 40 cents on the dollar in HQLAs and lend out 60 cents. For financial depositors, such as those from pension and investment funds, the entire balance is assumed prone to runs.

The implication on institutional depositors is that banks now expect more services out of them to maintain current relationships. Accounts that receive earning credit rates (ECRs) to offset fees on banking services should expect such rates to decrease. Banks also may impose higher fees for accounts they deem less desirable. In fact, many banks already pass higher FDIC assessment charges on to depositors. This trend likely will become more prevalent now that banks will not have full use of the deposits towards lending.

Takeaway: The LCR implication means that large banks have a strong disincentive towards accepting short-term non-operating deposits. Regulations, not the banks themselves, dictate deposit relationships. Deposits with fixed terms longer than 30 days and deposits at smaller banking institutions (less than $50 billion assets) are not directly impacted by the LCR rule.

Net Stable Funding Ratio and Deposits

Similar to LCR, the Basel III Accord requires banks' long-term assets to be sufficiently funded (Stable Funding/ Weighted Long-term Assets =/> 100%). While the LCR addresses a 30-day run-off scenario, the NSFR focuses funding risk over a one-year horizon. Wholesale short-term deposits are not stable funding sources.

While the NSFR rule is delayed until 2018 in the U.S., it is easy to see that banks will encourage more customer deposits to term out beyond a year to improve their NSFR status. Overnight and term wholesale deposits less than one-year will soon come under pressure.

Global Systemically Important Bank (G-SIB) Capital Surcharge and Deposits

A phrase now familiar with most cash management professionals, G-SIB refers to a group of 30 large, complex and globally interconnected banks named each year by the Financial Stability Board (FSB). FSB is a consortium of G-20 economies established after the 2008 financial crisis to monitor risks in global financial systems. The G-SIBs, formerly referred to as too-big-to-fail banks, face higher regulated capital burdens over and above what is required of all banks, called G-SIB capital surcharges.

Based on their current standing, additional capital surcharge ratios for the eight G-SIBs above the minimum required 7% Common Equity Tier 1 (CET1) capital ratio are: JPMorgan (4.5%), Citigroup (3.5%), Goldman Sachs (3.0%), Bank of America (3.0%), Morgan Stanley (3.0%), Wells Fargo (2.0%), State Street (1.5%), and Bank of New York Mellon (1.0%). Among the 22 other G-SIBs, many are active in the U.S., including HSBC (2.5%), Barclays (2.0%), BNP Paribas (2%), Deutsche Bank (2.0%), Credit Suisse (1.5%) and Mitsubishi UFJ (1.5%).

Wholesale deposits are impacted by G-SIB designations because the capital surcharge is based on a scoring system that takes non-operating deposits into account. In fact, Federal Reserve officials specifically pointed out the need to tie G-SIB capital surcharges to a bank's reliance on short-term wholesale funding. In order to maintain profitability and maximize shareholder values, G-SIBs have an incentive to reduce capital surcharges by reducing short-term wholesale funding needs, including non-operating deposits. Alternatively, G-SIBs need to collect additional fees on wholesale deposits in order to make up for the higher capital surcharges.

Things to Consider In the New Deposit Environment

The old workhorse, the transactional deposit account, is changing as a cash management tool, driven by regulatory initiatives. New rules allow banks to pay interest on checking balances, but they have little incentive to do so any time soon. Quite the opposite, many institutional depositors have to pay FDIC assessment fees for their entire balances, even though the fees only get them covered for the first $250,000. Large banks are compelled by a myriad of post-crisis financial regulations to shrink balance sheets and turn away non-operating deposits. Smaller banks, less impacted by the regulations but still recovering from the past downturn, are facing revenue challenges from low interest rates and may be less credit worthy for institutional deposits.

Faced with this new reality, cash managers should prepare for these changes and carefully evaluate their options. As they do so, we would like to offer these seven tips.

1. Deepen existing relationships: It is evident that banks prefer to retain operating deposits. An account is considered an operating deposit when it is part of a depositor's overall banking relationship including corporate trust, treasury services, and credit facilities. Consolidate banking services to a smaller number

of banks and reduce standalone deposit accounts to become more attractive to the banks and reduce overall costs.

2. Diversify: It may seem contradictory to the first point, but diversification remains important for business as well as counterparty credit reasons. It pays to keep relationships at a few strong banks suiting the depositor's needs rather than putting all of your eggs in one basket. Banks have different cost structures and objectives, which may result in different and shifting policies and incentives. Since banks prefer to bundle lending and treasury services with deposits, making a switch on the fly may not be easy should certain situations develop at a primary bank.

3. Size still matters: Despite regulatory issues and recent credit rating debacles at large banks, we still caution against moving deposit relationships to banks below the level of domestic systemically important institutions (D-SIBs, $50 billion asset threshold in the U.S.). For deposit protection reasons, we value extra regulatory oversight, including period stress tests, at G-SIBs and D-SIBs. Smaller banks receive less such attention, which may lead to higher risk to uninsured deposits.

4. Integrated counterparty risk assessment: Since the 2008 financial crisis, counterparty risk assessment has become a higher priority in corporate treasury management. We think it is imperative to incorporate deposit relationships into an organization's overall counterparty risk management in an integrated approach. Deposits as unsecured lending to banks need to be combined with credit exposures from money market funds, direct debt security holdings, derivatives and trade finance contracts. This integrated approach helps puts counterparty risk in the right perspective.

5. Liquidity is the name of the game: Depositors like to improve liquidity by staying in overnight deposits. Banks like to improve liquidity by accepting long-term deposits. This tension creates a liquidity-yield trade-off that presents both challenges and opportunities. Institutions better able to forecast and manage liquidity needs may improve yield potential by reducing transaction account balances, and increasing balances in long-term CDs and TDs, as well as in less liquid ECDs and YCDs.

6. Alternative liquidity vehicles: Challenges in corporate transaction deposits and prime money market funds open up opportunities to alternative liquidity vehicles. Such options may include separately managed accounts (SMAs) and direct purchases of government and corporate debt as well as repurchase agreements, private liquidity funds, ultra short-term bond mutual funds and exchange traded funds (ETFs). Although few alternative vehicles can truly replace the functions of transaction accounts, especially as sweep vehicles, they may fulfill certain functions not readily available in deposits alone.

7. Beware of higher interest rates: Lastly, institutional depositors should be aware of the impact of higher interest rates. After nearly seven years of near zero interest rates, higher short-term rates should bring higher yield potential and better bank profitability. However, some banks' credit profiles may deteriorate from higher credit costs to borrowers. This requires more scrutiny of counterparty credit assessment. Additionally, yield on time and savings deposits, set by individual banks, tends to lag some of the other liquidity vehicles, with yield set by the financial market.

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