BANKING REGULATIONS AND THEIR CONSEQUENCES

Linda T. Patterson
Patterson & Associates
www.patterson.net
Liquidity and Leverage

When banks pledge you collateral:
- They are loaning their own portfolio
- They reduce their access to the securities – liquidity
- They increase use of their securities – leverage

Banks have to reverse the potential impact
Banks face a wall of worry
- Regulatory hurdles
- Compliance nightmares

Regulations goals are admirable
- Manage through the next stress period
Protect the market and broader economy from the impact of an isolated stress event in a single bank

Strengthen regulation, supervision and risk management in the banking sector

Ensure banks have reliable, stable sources of funding in times of stability and stress

Improve the banking sector’s ability to absorb shocks arising from financial and economic stress

Basel III developed by the Bank for International Settlements established 1930 in Basel, Switzerland their goal is to help central banks with monetary and financial stability especially in stress periods.
Liquidity and Capital Components

**Liquidity Coverage Ratio**
- Requires banks to hold high quality liquid assets (HQLA)
- Requires reserves to meet all liabilities in a 30 day stress scenario
- HQLA includes cash, reserves, government & corporate debt
- Potentially limits banks from making loans

**Net Stable Funding Ratio**
- NSFR seeks to reduce a bank’s funding horizon by promoting longer term funding sources
- Reduces dependency on short term funding
- Encourages funding stability
- Aims to better assess funding risk
US G-SIBS Face Capital Requirements

Composition of Required Capital through transition period to 2019

Source: Board of Governors of the Federal Reserve System
Globally Systemically Important Banks (G-SIB)

- “too big too fail”
- US G-SIBs placed under stronger regulations
- Additional regulations add pressure on short-term
- Non-operating deposit balances act against the bank
- Capital buffers range from 0% to -5.5%

US method for G-SIB calculation varies from the Basel Committee calculation by including **Short-term Wholesale Funding (STWF)**; which adds further pressure on these banks’ treatment of **non-operating deposit balances**
Basel redefines how banks manage their balance sheets including liquidity

- Added (1) Supplementary Leverage Ratio
- 6% non-risk based leverage ratio to back-up LCR and NS for largest banks
- Added (2) Total Loss Absorbing Capital
Who are they?
- CitiBank
- JPMorgan Chase
- Morgan Stanley
- Bank of NY Mellon
- Goldman Sachs
- Wells Fargo
- Bank of America
- State Street

G-SIBS and their components being measured are:
- Size
- Inter-connectiveness
- Complexity
- Cross jurisdictional activity
- Short term funding sources
A bank’s basic profitability goal is to earn more interest on its book of loans than it pays in interest on deposits.

Typically its loans to customers (assets) should balance its deposits (liabilities).

Interest income minus interest expense should equal the net interest margin.

Basel III requires higher reserves thereby reducing interest income.
The classification of the balance has a direct usability of funding for banks and their ability to profit.

A higher % of non-operating balances are needed for HQLA.
- HQLA (Treasuries) provide liquidity but reduced return especially a traditional bank loan.
Increased demand for HQLA will reduce the supply available to serve as collateral for Public Sector deposits.

Banks will carry significantly higher costs on public sector and non-operating balances vs. corporate operating balances.

Banks will likely encourage non-operating funding to appropriate off-balance sheet vehicles such as money market mutual funds in the form of sweeps.

<table>
<thead>
<tr>
<th>For every $100 mm in corporate deposits</th>
<th>For every $100 mm in public deposits</th>
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<tbody>
<tr>
<td>-30 day run-off during event = 25%</td>
<td>-30 day runoff during event = 40%</td>
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<tr>
<td>-Required bank liquidity = $25 mm</td>
<td>-Required bank liquidity = $40 mm</td>
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### PUBLIC ENTITIES

- Some deposits may no longer be attractive to some banks
- Holistic banking relationships will be critical
- Operational accounts are key
- Banks may channel excess non-operating liquidity into alternatives
- Lower yields for excess liquidity is likely the new normal

### FOR BANKS

- Higher capital reserve requirements for all deposit types
- Collateralized public sector funds and non-operating balances will require higher reserves
- Banks are being impacted by higher capital requirements and higher compliance costs
Public Entities Aren’t As Pretty Anymore

- Public entities are more costly and less desirable to banks due to regulations

- Public entities will need alternatives
  - Banks can not afford large balances

- Why public entities?
  - Fluctuating balances through the year
  - Requirements for collateral
  - High service demands
  - High volumes
  - Always repetitive and competitive bidding
New World to Consider

- Collateral Alternatives
- FDIC Coverage Changes
- Money market mutual fund use
- Sweeps can help
- Alternative investments
Banks will view alternatives on a cost basis

Reduced amount of collateral available to pledge

Some banks will only offer FHLB letters of credit

Increased cost of collateral to the bank
  • Banks may charge a collateral fee
Why Letters of Credit

- Authorized by law (2001)
  - LOC from FHLB Regional Banks
  - Securities cost about 10-12 bps. and a LOC 5 bps.

- What is a LOC?
  - FHLB is a banker’s bank owned by the member banks
  - Credit backing comes from the member banks
    - Tenuous line to the Treasury
  - Event of default conditions
  - Time requirements for amount changes
  - System stress
Define authorized collateral (in policy and RFP)

- “Obligations of the US Government, its agencies and instrumentalities, including mortgage backed securities and CMO passing the bank test and FHLB letters of credit”
- Optional: Preference given to pledged securities
- Monitored and maintained by the bank at all times.
- Reports monthly from custodian

To assure you get a bank bid/proposal add LOC as a collateral option

You can prefer securities but authorize LOC to guarantee a bid
Alternatives to Collateral

- Investment options within the bank
- Investment options through the bank
- Investment options outside the bank
Sweeps Reduce Collateral and FDIC Assessments!

- Effective when rates are higher than now

- Sweeps move funds out of the bank daily
  - You are investing in a money fund security
  - Reduces balances on which FDIC fees apply

- Investment in fund (security) eliminates collateral
Stealth Assessments

- Banks are beginning to pass through FDIC fee
  - Not all banks pass through – ask! - verify

- Based on bank but basically 0.12%

- Higher balances hurt on collateral and FDIC fee

- Known by many names
  - FDIC does not allow use of FDIC name for fee
Direct Investment

- Investing in securities outside banks
- Yield curve changes have created opportunities
Changing FDIC Insurance

One not to worry about but to **act on**

Based on type of account – a change in definitions
- All **time and savings** accounts = $250,000
  - Includes **NOW** and money market accounts
- All **demand** accounts = $250,000
  - Includes interest bearing and non-interest bearing

Based on location of bank
- If the bank is **outside** the state all deposited are lumped together
- This has changed from ‘headquarters’”
FDIC Coverage

- Political Unit Accounts
  - If created under express authority of law
  - Has some function of government delegated
  - If it executes exclusive control of its funds for exclusive use

- Special cases
  - 4a and 4b corporations
  - Water supply corporations
Under the changed rules:
Pubic entity X has:
• $585,000 in demand accounts
• $195,000 in time and savings accounts
• The entity has $445,000 in FDIC coverage

FDIC coverage is calculated
• $250,000 (demand) + $195,000 (savings)
Collateral Fees

- Some banks may charge a fee for collateral
- Collateral costs banks about 10-12 bps
  - So $10 million pledged costs about $800 each month
- Charges can range in cost
- Charges may result from any deviation from PFCA
Collateral Reports

- A change resulting from expense reduction

- Banks do not have to send a collateral report
  - They must if you require it [2257.046]
  - Require it in RFP/bids and by contract
  - Require the report from your custodian
Read your collateral report each month. Try to get the report directly from the custodian.
Alternative Custodians

- Banks may want to move to a new custodian
- Money center bank move could be good
  - Often adds online inquiry and daily pricing availability
New regulations are directed towards safety, liquidity and stability

- Minimum 10% in securities convertible to cash in 1 day
- Minimum 30% in securities convertible to cash in 1 week

- Maximum WAM shortened to 60 days
- Maximum WAL of 120 days
  - weighted average life to reduce use of variables

- Monthly reporting to SEC on shadow prices

- Create procedures for stress tests
New Rules for MMMF

- Repo collateralized with US Obligations or cash only
- Ability to process at price not $1
- Maximum 3% in second tier securities (higher risk securities)
- Maximum of 5% in illiquid securities
- Know Your Investor requirements added
- Ability to suspend redemptions to prepare for liquidation
New Money Market Rules

- SEC has turned PRIME money funds into mutual funds
  - Not strive to maintain $1
  - Not authorized by PFIA
  - Fluctuate with market values (price)
  - Can reflect principal loss
  - Not authorized for bond proceeds

- What does your policy say?
  - Money market mutual funds, excluding prime funds or
  - Money market funds which strive to maintain a $1 NAV.
As the World Turns

- Banks are presenting new investment vehicles – investigate
  - ICS: Insured Cash Sweeps from Promontory Network (spread MMA)
  - CDARS: spread CDs

- Work with your bank on collateral and sweeps
  - Assure that sweeps are into MMMF

- As rates now change options will change in MMMF sweeps

- ECR rates will change slowly with higher rates
  - Monitor them versus outside rates for best value
  - At some point it is detrimental to maintain bank funds
Thank you!

Questions?