Liquidity investors and Basel III

Understanding the impact of new regulations on bank balance sheets will enable cash investors to most effectively segment and structure their portfolios

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Asset Management

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Basel III regulations redefine global standards for bank capital, liquidity and leverage, and will profoundly impact how banks manage their balance sheets. Liquidity investors need to understand how banks will treat deposits under the new rules. In this way, they can most effectively structure and segment their liquidity portfolios to gain the greatest benefit from the new rules and incentives, and maximize their investment returns.

- Deposits deemed to be non-operating cash will be less attractive to banks than those categorized as operating cash. Though the precise definition of operating cash is not yet final, it will be stricter than previous standards. Deposits categorized as non-operating cash, such as wholesale funding from financial services corporations, will move off bank balance sheets into alternatives such as money market funds (MMFs), separately managed accounts (SMAs) and self-directed individual securities.
- Though Basel III will not be completely implemented until 2019, in January 2014 European and U.S. banks started to report under the new regulations, and many large banks are choosing to follow the rules sooner than required.
- A centerpiece of Basel III—widely described as a "game changer" in the way banks view their deposits—is the liquidity coverage ratio (LCR). It aims to ensure that a bank can meet its liquidity needs in a severe stress scenario. Specifically, the regulation looks to make certain that a bank holds a sufficient stock of unencumbered assets that can be converted into cash within a day, without a decrease in value, to meet all of the bank's liquidity needs for a 30-day stress scenario. The ratio of high-quality liquid assets (HQLA) to a bank's expected net cash outflows during this period must be greater than 100%.
- Case studies of four liquidity investors—a distressed industrial company, an energy company, a hedge fund-of-funds and a large multi-service financial institution—illustrate how a bank would likely view their cash balances pre- and post-Basel III.
The regulations will have a particular impact on financial institutions, an important contingent of liquidity investors.
- Properly segmenting cash balances into operating and non-operating pools and making investments that maximize returns on both pools has never been more important. Liquidity investors should work with their banks to maximize their operating cash returns and with their investment managers to maximize their investment returns.

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Introduction

Central bankers and securities regulators have long sought to strengthen stability and control systemic risk in the global financial system, through both national regulation and a succession of international agreements. This daunting mandate became far more urgent in the wake of the 2008 financial crisis. Dozens of laws and regulations, including the 2010 Dodd-Frank Act in the U.S. and the 2013 Capital Requirements Directive (CRD IV) in Europe, now address a wide range of systemic vulnerabilities. Central to the global effort is Basel III, the most recent—and far-reaching—of the Basel accords.

Developed by the Basel Committee on Banking Supervision, an organization that brings together central bankers and other national financial regulators, Basel III redefines and extends standards for bank capital, liquidity and leverage. Like its predecessor accords, it aims to create a more resilient financial sector and ensure that banks can absorb the shocks of severe economic and financial stress.

Basel III's impact on the banking industry—specifically its impact on the way banks manage their balance sheets—has only just begun to be felt. But it will be profound. Cash investors (including corporate treasurers, insurers, investment firms and hedge funds) need to understand how banks must treat their deposits under the new regulations. While Basel III will not be completely implemented until 2019, key regulations have already begun to take effect, and many large banks are choosing to follow the new rules sooner than required.

Understanding the impact of Basel III on bank balance sheets will enable cash investors to structure their portfolios to gain the greatest advantage from the new rules and incentives.

Though approaches will vary, many liquidity investors will be compelled to keep at banks only those deposits that can be deemed operating cash. Deposits categorized as non-operating cash, such as wholesale funding from financial services corporations, will move into off-balance sheet alternatives such as money market funds, short-duration bond funds, separately managed accounts and individual securities. More recently, non-operational cash deposits have begun to exit banks and shift into off-balance sheet alternatives—moves that are expected to accelerate.

This paper describes the history of the new Basel accord, analyzes the substance of the complicated regulations it has generated and explores how cash investors can most effectively manage their liquidity investments in this changed regulatory environment. To illustrate the choices and decisions cash investors will be making, we present case studies of four liquidity investors, describing their cash portfolios and examining how a large U.S. bank would view their funding under the new rules. Throughout, our analysis is based on the U.S. interpretation of Basel III standards. Though specific details will vary from country to country, the principles behind the new regulations will prevail across global jurisdictions.

Critical components, investment impact

HISTORY OF THE BASEL ACCORDS

In late 1974 the central bank governors of the G-10 nations established what became known as The Basel Committee on Banking Supervision. The collapse of the Bretton Woods system of managed exchange rates in 1973 had led to several disorderly bank failures, and the group looked to facilitate coordination of banking supervision.

Today the committee reports to an oversight body, the Group of Central Bank Governors and Heads of Supervision, drawn from its 27 member nations. The committee's decisions have no legal force, and its accords are separately implemented by its member nations (and in European Union countries by the EU). Basel I, implemented in 1992, and Basel II, released in 2004, established minimal bank capital requirements and regulations for disclosure and supervisory review.

When Lehman Brothers filed for bankruptcy in September 2008 and credit markets effectively froze, the Basel Committee recognized an urgent need to strengthen capital adequacy and bolster banking regulation and supervision. In July 2010, the committee's overseer agreed on the overall design of a bank capital and liquidity reform package, now known as Basel III. Whereas Basel I and II concentrated on the asset side of a bank's balance sheet, Basel III focused on bank liabilities. In November 2010, Basel III's stricter capital and liquidity standards were endorsed by the leaders of the G-20.

BANK BALANCE SHEETS

Before we consider the details of the Basel III accord and examine its potential impact on banks and cash investments, it will be helpful to review the basic structure of bank balance sheets.

To put it most simply, a bank's assets are its loans, and its liabilities are its deposits. A bank's most basic goal is to earn more on its book of loans than it pays in interest on deposits.

Loans are also the source of significant risk, which is why the substance of a bank's loan book is critically important. Is the loan commercial or retail? How long a period does it cover? What is the initial interest rate, and what is its optionality (floating rate or fixed rate)? These are among the important characteristics defining a bank's loan book.

On the liability side of the balance sheet are deposits, a vital source of low-cost funding for banks. Banks borrow at low interest rates from depositors, creditors and small businesses. (In the current rate environment, checking, demand deposit and some savings accounts yield little or no interest to the depositor.) For banks, these deposits often serve as a very stable source of funding.

A critical measure of a bank's profitability is its net interest margin. A simple definition: interest earned on loans minus interest paid on deposits.

In the following section, we will delve into the complexities of the Basel III accord, focusing on its impact on bank balance sheets and the investment management of cash portfolios.

BASEL III: LIQUIDITY COVERAGE RATIO

The centerpiece of Basel III's liquidity framework is the liquidity coverage ratio, which aims to ensure that a bank can meet its liquidity needs in a severe stress scenario. Specifically, it looks to make certain that a bank holds a sufficient stock of unencumbered assets that can be converted into cash within a day, without a decrease in value (a higher standard than "cash and cash equivalents"), to meet all of the bank's liquidity needs for a 30-day stress scenario.

In the LCR calculation, banks must hold more HQLA than the difference between their calculated net cash outflows and inflows under a 30-day stress period (formula: HQLA/Net Cash Outflows >= 100%).

Basel III includes specific requirements for how banks should categorize their HQLA assets (Exhibit 1). The regulation lists the fundamental characteristics of HQLA, which include: low risk, ease and certainty of valuation, and low correlation with risky assets. Market-related characteristics of HQLA include: active and sizable market, and low volatility. Basel III notes that "central bank eligibility does not by itself constitute the basis for the categorization of an asset as HQLA."

In similar detail, Basel III defines the denominator of the liquidity coverage ratio, which is net cash outflows (Exhibit 2). The net cash outflow number reflects assumptions about which deposits (liabilities) will leave the bank in a time of systemic stress. The proportion of deposits expected to exit is referred to as the run-off factor. The more stable the source of funding is perceived to be, the lower the run-off factor applied to it. FDIC-insured retail deposits are deemed the most stable. Uninsured wholesale funding from financial institutions is considered the least stable and thus subject to the most severe run-off assumption of 100% (this assumes that 100% of the deposits will leave the bank in 30 days).

Banks have an incentive to hold a large quantity of Level 1 assets

EXHIBIT 1: DEFINITIONS OF ASSET QUALITY UNDER BASEL III'S HQLA RULES. THE U.S. PROPOSAL INCLUDES STRICTER DEFINITIONS AND EXCLUDES RMBS ALTOGETHER

	Description	Haircut/max. amount
Level 1	Cash, central bank reserves, central bank assets, sovereign debt	Zero/NA[1]
Level 2A	Government securities, covered bonds, corporate debt securities	15%/40%
Level 2B	RMBS rated AA or higher, corporate or covered bonds rated A+ to BBB, corporate equity securities	50%/15%

[1] Level 1 assets must make up at least 60% of total HQLA.

How quickly might assets exit a bank?

EXHIBIT 2: ASSETS (DEPOSITS) WITHOUT A MATURITY DATE; NET CASH OUTFLOW ASSUMPTIONS. THESE ARE A REPRESENTATIVE SAMPLE, DRAWN FROM THE U.S. INTERPRETATION OF BASEL III

Deposit type	Description	Outflow rate	Description	Outflow rate
UNSECURED RETAIL FUNDING OUTFLOW			**UNSECURED WHOLESALE FUNDING OUTFLOW**	
Stable retail deposits	Covered by FDIC and in transaction account or has another relationship with bank	3%	Operational deposits fully covered by FDIC	5%
Other retail deposits	Any retail deposit not a stable retail deposit; not fully insured by FDIC	10%	Operational deposits not fully covered by FDIC	25%
Other unsecured retail funding	Other retail deposits that mature within 30 days	100%	Unsecured wholesale funding from non-financial services sector fully covered by FDIC	20%
			Unsecured wholesale funding from non-financial services sector not fully covered by FDIC	40%
			Unsecured wholesale funding by a financial services company or affiliate	100%

Source: Bloomberg, Barclays, J.P. Morgan Asset Management; data as of August 1, 2013.

A MORE PRECISE DEFINITION OF OPERATING CASH

Before Basel III, banks could loosely define what deposits constituted operational cash balances. These balances could effectively include any cash that an investor deposited at the bank. Under Basel III, an operating balance will be more strictly defined. U.S. banks and the Federal Reserve have not yet settled on the final methodology that banks will use to define operational cash. But these balances will be required to have a "relationship" to another operating bank account, such as a sweep or custody account, a payment process or other service for which the bank can charge fees. The deposit must be a by-product of the related transactions. Furthermore, the deposit must meet a minimum value that would support those transactions. Under Basel III, operational accounts not fully covered by the FDIC would receive a 25% run-off factor. Unsecured wholesale funding from non-financial services corporations not fully covered by the FDIC would receive a 40% run-off factor. Holding more HQLA will mean that banks will have fewer deposits to be invested in longer-term assets.

A NEW BANK VIEW OF CLIENT DEPOSITS

The liquidity coverage ratio significantly changes how a bank views a client's deposits. If deposits are categorized as non-operating, by definition they become less attractive to a bank. For that reason, LCR is a major force driving cash balances out of bank accounts and into alternate investment vehicles. Even if a deposit is defined as operating cash under Basel III, a bank may deem it to be an "operating excess balance" and thus not an attractive prospect to take on to its balance sheet. To push such deposits off-balance sheet, a bank could lower the value assigned to these deposits (potentially to zero).

To accommodate this new bank calculus, a client with non-operating cash should consider placing its deposits with a bank in a term deposit, which carries a minimum 90-day maturity. Alternatively, the investor could move its deposits into a money market fund or separately managed account.

Moving cash off the bank's balance sheet could benefit both the bank and the client. It would help the bank meet its Basel III mandate and, if the client cash moved into a bank's MMF or SMA, it would keep intact the client-bank relationship, maintaining systems and reporting. As banks move toward full compliance with Basel III, they are expected to reduce their deposit rates. In such cases, a client could benefit by earning an equivalent or greater investment return in an MMF or SMA. (In the "Case Studies" section below, we consider how a large U.S. bank would view deposit balances from four different clients: a distressed industrial company, an energy company, a hedge fund-of-funds and a large multi-service financial institution.)

Many large banks have already begun to report lower deposit balances as a result of Basel III's liquidity coverage ratio. In its 2013 annual report, the Royal Bank of Scotland noted that its portfolio declined by £5 billion in the quarter due to "lower deposit balances as a result of the re-pricing of corporate and wholesale customer balances with higher liquidity coverage requirements." The bank also referenced that its liquidity portfolio remained stable at £146 billion in spite of bank "initiatives to re-price non-relationship deposits that generate higher liquidity coverage requirements."

The liquidity coverage ratio will likely cause banks to increasingly turn away wholesale funding. In his annual shareholder letter, JPMorgan Chase & Co. Chairman and CEO Jamie Dimon wrote, "Non-operational deposits… we take these deposits more as a service to the client—not because they are profitable for us. The new rules… [make] non-operational deposits hugely unprofitable; therefore, over time, banks probably will minimize this type of deposit."

As a bank re-evaluates what mix of deposits (and related run-off factors) it will accept, its decision will directly impact its net interest margin. If a bank's deposits have a high run-off factor, requiring the bank to hold, say, 80% of its assets in low-yielding HQLA, then 20% of its assets (the difference between 80% and the minimum level of 60% in HQLA) cannot be used to make loans. That will in turn reduce the interest income a bank makes on its loans and, all things being equal, narrow its net interest margin.

MARKET IMPACT OF THE LIQUIDITY COVERAGE RATIO

Investors are just beginning to calculate the potential market impact of the liquidity coverage ratio, but there is little doubt that the effects will be far-reaching. The new regulation will compel banks to hold a greater share of their assets in central bank deposits or Treasuries. Bank demand for these assets will increase as a result. Competing for Treasuries will be money market funds, which typically hold Treasuries to satisfy statutory requirements to hold minimum levels of overnight and weekly liquidity. Increased demand for Treasuries could also affect the market for repos, collateralized investments that are widely held by money market funds, since Treasuries serve as collateral for these transactions.

In assessing the direction of fixed income markets, investors will consider the impact of Basel III. It will be another factor, along with interest rate policy, the wind down of quantitative easing and liability-driven pension investing, that will help inform their market views.

NET STABLE FUNDING RATIO: LONGER-TERM LIQUIDITY ISSUES

Whereas Basel III's liquidity coverage ratio addresses short-term liquidity issues, focusing on reducing risk over a 30-day stress scenario, the net stable funding ratio (NSFR) targets longer-term liquidity issues, focusing on reducing funding risk over a one-year horizon. In particular, the net stable funding ratio intends to limit a bank's over-reliance on short-term wholesale funding, encourages better assessment of funding risk, and promotes funding stability. This rule requires that the ratio of stable funding to weighted long-term assets must be greater than 100% (formula: Stable Funding/ Weighted Long-Term Assets >= 100%). Stable funding includes customer deposits, long-term wholesale funding and equity, and excludes short-term wholesale funding.

Weighted long-term assets are defined and quantified as follows:

- 100% of loans that extend for more than one year
- 85% of loans to retail clients that extend for less than one year
- 50% of loans to corporate clients with a remaining life shorter than one year
- 20% of government and corporate bonds

The net stable funding ratio targets mismatches between the liquidity profile of a bank's assets and liabilities, giving banks an incentive to use stable sources of funding.

CAPITAL QUALITY, QUANTITY AND G-SIFIS

On the critical subject of regulatory capital, Basel III builds on the three-pillar framework of the earlier Basel II accord. It also introduces new requirements that specifically apply to 30 globally systemically important financial institutions (G-SIFIs).

THE OTHER TWO PILLARS OF BASEL III

Risk management and supervision: The second pillar of Basel III examines supervisory review and risk management. The new Pillar 2 requirements address firm-wide governance; capturing the risk of off-balance sheet exposures and securitization activities; managing risk concentrations; providing incentives for banks to better manage risk and return over the long term; and sound compensation practices, among other measures.

Market discipline: Procedures should be included in the bank's policy to accommodate exceptions, specifying the type of circumstances in which they can take place (for example, extraordinary market conditions). A formal process should outline who is responsible for implementing and approving exceptions to the policy.

In November 2011, the Financial Stability Board, an international regulatory body set up in April 2009, published the first list of G-SIFIs, which is now updated annually (**EXHIBIT 3**).

G-SIFIs get special treatment from regulators

EXHIBIT 3: GLOBALLY SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS (G-SIFIS) AS DEFINED BY THE FINANCIAL STABILITY BOARD

Bucket	G-SIB* (in alphabetical order)	Bucket	G-SIB* (in alphabetical order)
3.5%	none	1.0%	Crédit Agricole
2.5%	**J.P. Morgan**		Groupe BPCE
	HSBC		ICBC, Ltd.
2.0%	Barclays		ING
	BNP Paribas		Mizuho
	Citigroup		Nordea
	Deutsche Bank		Royal Bank of Scotland
1.5%	Bank of America		Santander
	Credit Suisse		Société Générale
	Goldman Sachs		Standard Chartered
	Mitsubishi		State Street
	Morgan Stanley		Sumitomo
1.0%	Agricultural Bank of China		UBS
	Bank of China		UniCredit Group
	BoNY Mellon		Wells Fargo
	China Construction Bank		

*G-SIB: Globally Systemically Important Bank

Source: Financial Stability Board; data as of November 2015.

Basel III increases both the quality and the quantity of the regulatory capital base, reduces leverage and enhances risk coverage of the regulatory capital framework.

Under Basel III, Tier I capital must make up at least 6% of risk-weighted assets after deductions, of which 4.5% is common equity and retained earnings (up from an earlier level of 2.0%). An additional 2% of risk-weighted assets can be Tier 1 or Tier 2 capital. There is also an added capital conservation buffer, consisting of 2.5% of risk-weighted assets, bringing the total requirement to 10.5%.

The new accord requires that contractual terms of capital instruments include a clause that allows the write-off of capital instruments or their conversion to common equity if the relevant supervisory authority judges the banking entity to be non-viable. This increases the contribution that private sector investors would make to the resolution of a non-viable entity.

Addressing what it refers to as “the procyclical amplification of financial shocks throughout the banking system,” Basel III introduces a “countercyclical buffer.” It can be imposed within a range of 0% to 2.5% when bank supervisors judge that credit growth is producing an unacceptable increase in systemic risk.

Under Basel III, G-SIFIs must meet all those requirements and then set aside additional levels of loss absorbency. These range from an additional 1.0% to 2.5% in common equity Tier 1 capital (CET1).

THE LEVERAGE RATIO

Excessive leverage, on- and off-balance sheet, has been a defining feature of almost all financial crises. Basel III aims to contain leverage in the banking system, in large part through a non-risk-based leverage ratio that includes off-balance sheet exposures.

The leverage ratio: Tier 1 capital/total exposure=> 3%

Total exposure is defined as the exposure value of all on- and off-balance sheet assets, including derivatives exposure consisting of potential future exposure (PFE) for derivatives contracts, securities financing transaction (SFT) exposures, unfunded lending commitments and standby letters of credit.

The accord states that the leverage ratio will serve as a “credible supplementary measure” (essentially a backstop) to Basel III’s risk-based capital requirements.

For the eight biggest U.S. banks (Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase & Co., Morgan Stanley, State Street and Wells Fargo), a supplementary leverage ratio (SLR) applies. The leverage ratio at the bank operating company level will be 6%, an enhancement to the current 3%, and at the holding company level it will be 5%. This will force these banks to hold much more Tier 1 capital relative to total exposure.

IMPLEMENTATION TIMELINE

Basel III's various components will be phased in over time, with all elements scheduled to be in place by January 1, 2019. In 2015, for example, banks will begin to disclose their leverage ratios and will have to meet 60% of the minimum requirement for the liquidity coverage ratio (70% in 2016, 80% in 2017, 90% in 2018 and 100% on January 1, 2019). See **EXHIBIT 4** for a complete schedule of Basel III implementation.

Basel III calls for complete implementation by 2019

EXHIBIT 4: IMPLEMENTATION TIMELINE FOR BASEL III MEASURES (ALL DATES ARE AS OF JANUARY 1, 2014)

	2011	2012	2013	2014	2015	2016	2017	2018	As of January 1, 2019
Leverage ratio	Supervisory monitoring		Parallel run Jan. 1, 2013–Jan. 1, 2017 Disclosure starts Jan. 1, 2015					Migration to Pillar 1	
Minimum common equity capital ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer						0.625%	1.250%	1.875%	2.5%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.750%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs[1], MSRs[2] and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum total capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10-year horizon beginning in 2013						
Liquidity coverage ratio – minimum requirement	Observation period begins		Publishing of LCR data		60%	70%	80%	90%	100%
Net stable funding ratio	Observation period begins							Introduce minimum standard	

[1] DTAs: deferred tax assets.

[2] MSRs: mortgage servicing rights.

Source: Basel Committee on Banking Supervision, Bank for International Settlements.

Case studies

Although the new accord will not be completely implemented until 2019, in January 2014 European and U.S. banks started to report under Basel III. Some key regulations have taken effect, and, facing competitive and market pressure, many large banks are choosing to follow the new rules sooner than required. As a result, cash investors are focusing on how banks will evaluate client deposits under the new regulations and recalibrating whether their cash portfolios are best suited for money market funds or bank deposits.

In the following table, we present case studies of four types of cash investors and illustrate how a bank would likely view their cash balances pre- and post-Basel III.

CASH BALANCES, PRE- AND POST-BASEL III: BANK AND NON-BANK INVESTMENT OPTIONS FOR FOUR TYPES OF LIQUIDITY INVESTORS

Distressed industrial company: non-operating balances	Pre-Basel III	Post-Basel III
A distressed industrial company is required to hold excess cash balances. Under Basel III, these excess cash balances are deemed non-operating because they are not tied to any cash management services provided by the bank.		
$200 million money market deposit account (MMDA)	12 bps	Zero
Time deposits	12 bps	Zero
MMF with repo	Not used	Investments moved to MMF, where a competitive yield can be earned
Basel III changes how the bank may use this cash, creating a disincentive for the bank to hold the deposits. These cash balances are considered unsecured wholesale funding from a non-financial services company, not fully covered by the FDIC. They would receive a 40% run-off factor, meaning that the bank must assume that 40% of the cash will be withdrawn in one day. Therefore the rate of 12 bps that the client earned pre-Basel III is reduced to zero. Other off-balance sheet alternatives are considered, including MMFs and direct investment into acceptable securities where a more acceptable market rate of return can be earned.		
Energy company: operating balances	**Pre-Basel III**	**Post-Basel III**
The cash balances of an energy company are categorized as operating balances because the bank provides cash management services such as payment servicing, incoming receipt processing, information services and crude settlement processing.		
Balances considered operating balances	Earnings credit rate (ECR), Interest-bearing deposit accounts	ECR Interest-bearing deposit accounts
Because the balances are operating and the client is a non-financial company, the bank is very willing to accept the balances on its balance sheet. They are considered operating deposits—not fully covered by the FDIC, they would receive a 25% run-off rate assigned to them. It benefits the client to leave these balances with the bank.		
ABC Capital Management (hedge fund-of-funds)	**Pre-Basel III**	**Post-Basel III**
An investment management firm offering hedge funds-of-funds has two types of cash: management cash, which is used by the management company to pay bills, and strategy cash, which represents the cash of each of the firm's strategies or funds.		
Management cash $100 million	ECR, MMDA	ECR, MMDA
Strategy cash $300 million	ECR, MMDA	Not wanted by the bank
Here the management cash can still be considered an operating balance, not fully covered by the FDIC and receiving a favorable 25% run-off assumption. However, the strategy cash would receive the least favorable cash outflow assumptions for deposits, considered unsecured wholesale funding by a financial services company and receiving a 100% run-off rate. In general, banks have a strong disincentive to accept deposits from financial firms. The strategy assets would be better placed in a MMF or separately managed account.		
Large multi-service financial institution	**Pre-Basel III**	**Post-Basel III**
Financial institutions typically have several sources of cash that are placed as deposits with other banks. These sources of cash can come from Treasury services, investor services, prime brokerage, custody, private banking and institutional asset management.		
Treasury services, investor services, prime brokerage, custody, private bank, asset management	MMDA, time deposits, sweep accounts	Not wanted by the bank
Balances from financial institutions are considered unsecured wholesale funds not covered by the FDIC. Therefore they have a 100% outflow assumption applied to them. These balances would be better off moved to a MMF or separately managed account.		

For illustrative purposes only.

Conclusion

From the perspective of a liquidity investor, Basel III has one critical component: it has redefined how a bank views its deposits. New regulations compel banks, when evaluating a prospective or existing deposit, to consider both the type of client and the type of cash to determine how valuable the funds are to the bank. All else being equal, deposits deemed to be non-operating cash will be less attractive to banks than operating balances.

A cash investor looking to maximize the return on its liquidity portfolio must understand the nuances of Basel III and consider a bank's likely treatment of its cash balances. Properly segmenting these balances into operating and non-operating pools and making investments that maximize returns on both pools has never been more important. Cash investors should work with their banks to maximize their operating cash returns and with their investment managers to maximize their investment returns.

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NEXT STEPS

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