THE BANKING CONUNDRUM: IMPLICATIONS OF AN EVOLVING REGULATORY ENVIRONMENT

John Ahearn, global head of trade finance at Citi, discusses the implications of an evolving regulatory environment.

Following the financial crisis, gaps in the international capital framework established by Basel I and II were exposed. While the regulatory framework focused on the capital adequacy of banks, their ability to adequately fund operations in a stress environment was not measured, creating grave concerns amongst regulators. To address these perceived shortcomings, regulators around the world have proposed new metrics in an attempt to harmonise liquidity standards.

These new regulations are setting in motion changes that will have significant impacts for banks as well as their corporate customers, particularly those conducting business on a global basis. For that reason, it is important for all market players to stay abreast of these changes and adjust their banking strategies accordingly.

The changing value of deposits
One of the key regulatory focuses is on bank liquidity, as regulators seek to ensure that banks can withstand a liquidity drain during a stress scenario. Two ratios have been proposed to measure adequacy of funding and inflows against expected requirements and outflows in the event of a crisis. The Liquidity Coverage Ratio (LCR) addresses liquidity risk over a 30-day time horizon. Similarly, Net Stable Funding Ratio addresses longer-term stable funding requirements over a one-year horizon. In assessing potential outflows, regulators have taken the view that deposits provided by financial institutions are less stable and more likely to decline and flow out in times of systemic or specific counterparty scenarios.

Complicating the situation, regional regulators may impose stiffer ratios within their countries, bringing further uncertainty to how banks will value deposits in the future. The introduction of new deposit and funding options that are aligned to capital and liquidity frameworks, such as 30-Day Call Accounts, may prove highly attractive for banks and corporates looking to maximize returns.

Global ambitions made tougher by potential fragmentation of banks
Corporates seeking to take advantage of global growth opportunities may face new challenges from the fragmentation of banks, as banking networks fracture...
Market pricing is unrealistic: capital costs have gone up with Basel III and could be as high as 16.5%, but this cost has not been priced through to the asset side of the business.

Banks are struggling to meet the new higher leverage ratio non-risk “backstop” and this is likely to become a constraint to asset growth. Regulators are keen to increase capital requirements in a universal way, there’s a concern about the inconsistent use of banks’ advanced models and a wish to have efficient cross-bank comparisons. Yet, this doesn’t allow for the true risk of the underlying asset to be assessed.

With the new Liquidity Coverage Ratio the traditional correspondent banking model is challenged. Capital has become more expensive as the value of deposits decline and this is forcing changes to traditional funding models and prices and resulting in a need for new correspondent banking models to emerge.

Compliance is becoming increasingly complex with continued strengthening of KYC, AML and other regulatory needs increasing the cost and time of trade finance. Banks need to invest resources and technology to address these requirements.

This is becoming a practical necessity.

Basel III is forcing banks to reinvent how they use their balance sheets with a new spotlight on risk distribution, deposit strategies, and intra-day liquidity management. Regarding risk distribution, Basel III pressurizes banks to rethink how they will use their balance sheets to generate returns shifting the emphasis from the traditional book and hold approach to an originate and distribute model.

Basel III also forces banks to adjust their deposit strategies, as the definition of LCR-friendly is introduced and intra-day liquidity becomes as valued asset requiring monitoring.

As banks grapple with regulatory changes, many will move to trim existing footprints, exit non-core businesses, and reassess client relationships in light of regulatory value, re-pricing credit and use of balance sheet, both for assets and liabilities. In response to changes in the marketplace, corporates that value global experience and depth of expertise should also reassess relationships and look to enter into partnerships that address mutual requirements.

The evolving nature of the regulatory landscape and the impact of individual interpretations and requirements are creating confusion and adding complexity to the banking industry. This has made it imperative for corporates to look more closely at how their relationships will be affected, and develop strategies that take the greatest advantage of changing business models.

Please visit the Citi team at Sibos 2014 at Stand Location D20.