Basel III Implications in Asia: A Transaction Banking View

Basel III is the latest buzzword in banking and finance across Asia's markets. Particularly in Singapore, Hong Kong, China, India and Australia, regulators are now focusing on Basel measures as this important regulatory change is meant to be fully implemented by January 2016.

While the core global framework remains unchanged, there are differing implementation timelines and compliance considerations for corporates in Asia. This article provides an overview of key considerations and implications of Basel III that corporate treasurers need to think about, especially in the area of treasury and liquidity management.

What is Basel III?

The Basel III framework is divided into two main areas:

i Governance over regulatory capital where banks are required to meet certain solvency requirements.

ii Assets and Liabilities Management (ALM) where banks have to ensure there is sufficient liquidity and quality funding sources available.

While corporate treasurers should be aware of the availability and costs of hedging and debt instruments as a result of the capital requirements on banks, we will focus our attention here on the latter measure governing ALM as it is the most relevant for transaction banking. This framework includes Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). LCR requires banks to ensure that they can withstand a 30-day idiosyncratic stress scenario. NSFR requires banks to take a longer term ALM view to ensure stability and resiliency.

Resulting Impact of LCR on Banks

The greatest impact for corporates results from banks having to maintain LCR requirements. Banks now have to efficiently maintain High Quality Liquid Assets (HQLA) such as cash, central bank deposits and bonds against potential run off of deposits or funding needs that use up cash. To be 100% compliant with Basel III, a bank must have sufficient HQLA to meet the deposit run off within a 30-day timeframe.

So what does that mean? Banks will have to take a closer look at their HQLA sources, of which corporate client deposits constitute a significant source.

Basel III provides certain categorization as to what can be included in HQLA with run off assumptions on different types of client deposits. In a nutshell, operating balances have been assigned a low run off assumption (25%) while non-operating balances have high run off assumptions (40%).

While segregation of operating vs non-operating deposits is a requirement under the LCR framework, it does leave room for banks to define how this categorization may be implemented. In addition, tenor deposit products such as time deposits and fixed term deposits which are popular with corporates for short term investments would be of lower LCR value to a bank (i.e. high run off assumptions) unless deposits are held to a term of no less than the 31 days maturity.

Priority	Deposit Products	Liquidity Value[1]
Operating A/Cs	Non-Interest Bearing, Earnings Credit Rate, Interest Bearing Demand Deposit Account	75%
31+ Day Minimum Maturity Time Deposit	31/45/60/90 MMTD	100%
Time Deposits	TDs (>30 days)	100%
Non-Operating A/Cs	IBDDA, Money Market Deposit Account, ECR	60%
Time Deposits[2]	TDs (<30 days)	60%
Public Sector Collateralized Deposits	NOW, MMDA, IBDDA	60 - 100%

[1] Liquidity Value represents the complement of the LCR run-off ratio, i.e. 1-LCR run-off. For example, Corporate Operating A/Cs have a B3 run-off of 25%, or a Liquidity Value of 75%

[2] Early breakage from TDs is not allowed

Implications on Corporate Transaction Banking Flows

1 Potentially lower interest revenue in developing countries

Asia has a diverse operating and regulatory environment, especially in developing markets where cross-border cash movements are restricted and investment options are limited. As such, companies have played a rather reactive role in managing cash positions relying on traditional bank deposit products to earn interest revenues.

In the Basel III environment, banks may adopt different pricing strategies depending on the LCR value of deposits and payout, less non-operating and time deposits. However, companies will no longer be able to extract the same value from their bank deposits as investment options still remain limited, and (with the exception of China), cross-border controls are still in place. Consequently, treasurers have to conduct a deep dive to understand profit and loss impact, and evaluate options of changing investment policies to include other local investment options which may have higher risks.

2 Opportunities to create strategic cash positions

With increased LCR value applied for non-operational cash (or what is generally termed "strategic cash"), treasurers should plan for investments with tenor of 31 days or longer. Overall, there will be an increasing focus to evaluate the company's balance sheet needs, tenors and ways to create efficiencies to ensure longer term insight from cash forecasting. Treasurers can also prioritize key banking relationships, particularly partnering with banks that are well capitalized and well-funded.

3 Impact on notional pooling

Although the Basel III framework does not have direct requirements for the treatment of notional pooling as a liquidity solution, the basis of offer has been widely debated in the industry. The basic premise of notional pooling is the legal rights of set off and ability net deposits on balance sheet for a bank. For most US based banks, this may not be much of a consideration as the US GAAP allow banks to net balances, subject to legally enforceable rights being in place. However some of the European banks may have to review their notional pooling product offering due to the difference in accounting treatment under IFRS.

If banks have to consider positions within notional pools as "gross", inevitably that might impact their liquidity cost. Consequently, this will have potential implication for corporates on their bank's ability to provide legal right of set off or cross guarantees and potential requirements to settle positions periodically. We anticipate that notional pooling will be an area that will evolve as we go into full implementation of Basel III.

4 Change in company policies and treasury KPIs

Aside from reviewing investment policies to allow for new investment instruments to optimize yield enhancement objectives in developing Asia markets, we have also seen many treasurers move key performance indicators away from revenue generating KPIs to cost efficiency indicators.

5 Increased corporate investments into Money Market Funds (MMF)
LCR is quickly becoming the new DNA for bank balance sheets. In order to accommodate LCR requirements, banks and their clients alike will look at off balance sheet options for "excess cash". Banks will benefit by meeting LCR requirements while corporates will benefit by enhancing yield on their strategic cash. Companies with large cash holdings may look at segregated mandates with MMF providers to optimize returns on short to medium term investments, subject to their investment policies and risk appetite.

Strategic Considerations for Corporates

As a best practice, treasurers should evaluate the impact of Basel III by applying the changes mentioned above across their company's operations in Asia. In practical application, while there may still be opportunities to earn interest revenue pre-Basel III implementation, treasurers can expect some degrees of variance across the markets, which will make centralization and administration of cash flow positions challenging.

Looking ahead, corporates and transaction banking practitioners should keep abreast of the rolling effects of Basel III on their investment and liquidity management practices to ensure minimum impact to the overall business strategies.

Optimizing Banking Relationships in the Basel III Environment: Top 3 Strategic Considerations for Corporates

- Which banking partner can provide the most comprehensive cash management platform across the company's footprint?
- Which banking partner is able to demonstrate speed and efficiency in centralizing liquidity (e.g. regional or global pooling) and executing transactions?
- Which banking partner has the ability to provide appropriate investment options that are Basel III friendly?

Banks will benefit by meeting LCR requirements while corporates will benefit by enhancing yield on their strategic cash. Companies with large cash holdings may look at segregated mandates with MMF providers to optimize returns on short to medium term investments, subject to their investment policies and risk appetite.

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