Basel III was developed to ensure that the banking system is able to withstand shocks in a stress event, primarily by aligning bank deposits with reliable funding sources. As a result, operating, or transaction-related, business and balances, that are deemed stable in nature will increase in importance for many banks, whereas balances regarded as non-operating will be less desirable because of the cost to hold this cash on deposit.

This value shift could have a broad impact on how an organization manages its bank relationships and investment strategies. Moreover, there could be unintended consequences to the cost and availability of bank credit. It is critical to understand the implications on all fronts and reassess strategies for managing treasury operations and deposits.
As a result of Basel III, banks are shifting their approach and strategies across many areas, especially treasury services. As a treasury professional, it is critical to understand how these market changes will impact three areas: bank relationships, investments and credit facilities. Moreover, if your firm is operating on a global scale, you will need to consider the implications for each region and line of business. Now is the time to reassess your existing treasury practices for this new environment.

**Bank relationship strategy**

Corporates tend to divide payments, receipts and liquidity management among their relationship banks. When banks seek additional business, corporates frequently respond by reallocating excess balances since these are the easiest to move, allow for maximization of yield (or ECR offset) and help maintain the bank relationship. Under Basel III however, banks now require cash flows from transaction services to support deposits and to substantiate balances as operating balances.

Given these new requirements, treasurers should reconsider their approach to managing your bank relationships by determining the optimal way to distribute the wallet of treasury services across banking partners. Ideally, this distribution weighs efficient treasury management processes with deposit placement needs.

### CALL TO ACTION

- **Know yourself**
- **Determine** the optimal approach to allocating operating business
- **Reassess** counterparty risk based on increased risk transparency

#### Know Yourself Process

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<th>Step</th>
<th>Description</th>
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<td>Validate Credit Rating</td>
<td>Agency ratings or ask bank(s); validate assumptions and input</td>
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<tr>
<td>Assess Transaction Flows</td>
<td>Types of transactions, by entity and country - changes required for efficiency and cost reduction</td>
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<tr>
<td>Optimize Working Capital</td>
<td>Transaction flow analysis reveals opportunities for working capital improvement</td>
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<tr>
<td>Leverage Internal Cash</td>
<td>If working capital is optimized, more opportunities to utilize internal cash; review tax implications</td>
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<tr>
<td>Determine Liquidity Requirements</td>
<td>Funding needs for short, medium term; excess cash levels and tenor - by currency</td>
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<tr>
<td>Quantify Exposure/Risk</td>
<td>What are company’s primary exposures - strategic, institutional, credit, interest rate, currency?</td>
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**Determine the optimal approach to allocating operating business**

Based on this self-assessment you may find it necessary to rationalize bank relationships and spread your treasury business across different, and perhaps fewer, providers. To determine the appropriate distribution, you should go beyond a traditional scorecard or a share-of-wallet assessment of bank fees, and expand it to a risk adjusted return on capital (RAROC) analysis of all banking partners. The RAROC is a measurement tool that determines how banks view relationship profitability based on risk, reward and capital outlay. In some cases, it may reveal that the risk/return that some banks are receiving is not in alignment and, as such should be revisited as part of the reallocation process. Regardless of the output, the RAROC serves as a good basis to begin discussions with your banking partners to arrive at the optimal distribution for your company.
Reassess counterparty risk based on increased risk transparency
With banks investing in tracking metrics required under Basel III, there is now an increased level of transparency around bank stability and counterparty risk. These metrics, typically available through the banks’ annual reports, offer a new level of granularity into their ability to pass the Federal Reserve’s Comprehensive Capital Analysis and Review for capital adequacy, stress tests and other Basel III requirements. This new level of transparency into measuring counterparty risk can play a significant role in assessing bank relationships and finding the best way to award operating business.

Investment strategy
Basel III will lead to a reduction in bank appetite for non-operating balances on their balance sheets due to the costs related to holding these balances. Some banks will pass on the costs of these balances perhaps in the form of reduced, zero or even negative account interest. A negative rate environment, which already exists in some markets, increases the potential for banks to charge for keeping deposits on the books, thereby negatively impacting returns or leading to higher fees. In light of this, banks are revisiting their liquidity solutions and identifying options to exit certain deposit products and invest in others, such as off-balance sheet investment solutions which are viable alternatives under Basel III.

CALL TO ACTION
- Consider off-balance sheet investment alternatives
- Update your investment policy
- Assess how best to deploy non-operating deposits

Consider off-balance sheet investment alternatives
Limited deposit options for non-operating balances will require you to consider the range of investment alternatives available today and to reassess investment strategies. Investment alternatives may include, for example, Money Market Mutual Fund (MMMF) sweeps and separately managed accounts. Evolving prime MMMF reforms could determine whether these funds are an allowable option for excess liquidity.

A RAROC Analysis: Assessing Business Allocation Across Banks
An understanding of how you divide your share of wallet across your banks, combined with a RAROC analysis and counterparty risk assessment, can help you find the optimal allocation of your company’s operating and deposit business. A RAROC analysis looks at the entire relationship, factors in an appropriate level of risk, compares risk to reward and accounts for the capital needed to support the relationship. This model can be used to determine how the banks view their relationship with your company.

The RAROC analysis considers all banking relationships against multiple assessment categories, including total deposits, transaction fees, credit commitment, LCs and guarantees and associated fees, FX amounts, trust, custody, credit cards and any other allocated business. Assumptions will need to be made for items such as bond or credit ratings, spread on investments and, FX and ratio requirements for credit, all of which could be lower or higher with Basel III.
- A high RAROC and share of wallet indicates that the bank likely has a favorable view of your relationship
- A lower RAROC and share of wallet indicates a possible imbalance, which could render your business less desirable to the bank. Business reallocation may be in order to retain the relationship

It is important to realize that your internal RAROC analysis will not be identical to any specific bank’s analysis due to varying assumptions and limited insight into cost structures (for example, some services like lockbox or coin and currency may not be as profitable to your banks even if they make up a larger proportion of your fees). However, a successful RAROC should be directionally correct and will serve as a valuable tool in opening conversations with your banks about their assumptions related to your business.

Update your investment policy
Given the expectations for lower demand for excess cash balances, it is important to review and update your investment policy to ensure that it provides enough alternatives for deposit placement, particularly in regard to off-balance sheet investments. This includes reviewing objectives, liquidity targets and risk limits from a counterparty, issuer and asset standpoint.

Assess how to deploy non-operating deposits
There is an opportunity to more broadly assess how to deploy non-operating balances. Beyond off-balance sheet investments, would reinvesting the funds internally be a better choice? This excess cash may be better utilized for the funding of strategic projects or acquisitions.
Credit strategy

There is an expectation that banks also will be less willing to extend credit, an unintended consequence of Basel III. Experts anticipate a contraction in the credit market as banks become more selective in allocating credit or increase the cost associated with drawn and undrawn credit facilities. Banks are likely to use credit to incentivize clients to reallocate operating business to them.

While Basel III has been the driver of these changes, the effort of banks and corporates to re-align their strategies can make cash and liquidity management structures for both parties more efficient. As you engage your team and other internal stakeholders in this effort, you should work with your banking partners to understand their strategies to allow for informed decisions that will prepare your company for the current environment.

CALL TO ACTION

- **Determine** the right size for credit facilities
- **Review** global liquidity management
- **Improve** working capital efficiency

**Determine the right size for credit facilities**

It is critical to ensure that credit facilities align with usage. Current revolvers may have taken advantage of the historically low rate environment over the past few years and may need to be right-sized to avoid incurring unnecessary credit costs. To do this, take a closer look at your company’s credit needs by market and/or line of business. You should also consider how expanding your existing global operations will result in variations in credit requirements across your company’s footprint.

**Review global liquidity positions**

Any effort to reduce reliance on credit should be accompanied by a review of liquidity. Companies often have pockets of excess cash and negative balances around the world, so a comprehensive approach to sizing the funding and investment needs should include a global reassessment of liquidity usage and requirements and then a determination on how best to concentrate global cash and deploy excess liquidity. In addition, identify where you have trapped cash and review available options to extract value from these either at a local or global level.

**Improve working capital efficiency**

Efforts to continually improve working capital efficiency will increase in importance to avoid drawing unnecessarily on credit revolvers. Review levers such as payment terms driving DPO (Days Payable Outstanding) or accounts receivables processes and payment options that impact DSO (Days Sales Outstanding), to identify opportunities to improve the ability to internally fund operating activities.
Basel III Glossary

Global Systemically Important Banks (GSIB) – Thirty banks (as of Nov 2014) identified as having the potential to disrupt the market in an isolated stress event based on an assessment of the following criteria: size, interconnectedness, complexity, cross-jurisdictional activity, and short-term wholesale funding. The higher the score, the greater the amount of capital a bank must hold for a given level of assets. The criteria and methodology to determine a GSIB designation is outlined in Basel III.

High Quality Liquid Assets (HQLA) – Assets that display the following characteristics: low risk, ease and certainty of valuation and low correlation with risky assets. Examples include: cash, central bank reserves, central bank assets and sovereign debt.

Leverage Ratio – An additional metric that serves as a backstop to Basel III’s risk-based capital requirements. It ensures that banks are appropriately capitalized based on their exposure. The minimum leverage ratio requirement is 3%, while the U.S. implementation is 5.5% for bank holding companies and 6% for banks.*

- Tier 1 capital/total exposure >= required leverage ratio*

Liquidity Coverage Ratio (LCR) – Metric that ensures that a bank holds a sufficient amount 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

- HQLA/Net Cash Outflows in 30 days >= 100%

Net Stable Funding Ratio (NSFR) – Focused on reducing funding risk over a one-year horizon, the NSFR aims to limit a bank’s over-reliance on short term wholesale funding, encourages better assessment of funding risk, and promotes funding stability.

- Amount of Stable Funding/Weighted Long Term Assets >= 100%

Operating Deposits – Cash in deposit accounts that directly support transaction activity with the bank. These deposits are deemed as reliable sources of funding and require less capitalization than other deposits.

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