THE EFFECT OF REGULATORY REFORM ON MANAGEMENT OF SHORT-TERM CASH

With the financial crisis in the rear-view mirror, the economy slowly improving and regulatory reform implementation well under way, it makes sense to take stock of your short-term cash positioning in the context of these events.

Several reform initiatives are on the books, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Securities and Exchange Commission (SEC) money market mutual fund rules and Basel III. Other initiatives are still pending or specific regulations have yet to be written. These reforms are aimed at preventing another crisis largely by changing the way financial institutions operate and by enhancing their ability to provide safety and stability to their customers. Some of these changes will impact how businesses manage their short-term cash.

An organization’s short-term cash can be broken into three distinct parts: operating cash, reserve cash and strategic cash. Each plays a critical role, from the daily liquidity required to keep things running smoothly, to creating a cushion against unforeseen liquidity demands, to specific funding needs that may occur over the next several weeks or months.

Understanding the regulatory changes and how they will impact various products used to invest or hold short-term cash is vital to optimizing its value to your firm.

DODD-FRANK WALL STREET REFORM – OVERVIEW

Dodd-Frank is the most significant change to the banking landscape since the Great Depression. Dodd-Frank has 16 titles addressing myriad subjects and includes:

- Requirements that various government agencies issue a total of 243 new regulations
- Requests for 67 studies
- Requests for 22 periodic reports
- Changes to the regulatory structure of financial firms
- Creation of the Financial Stability Oversight Council
- Creation of the Office of Financial Research
- Creation of the Consumer Financial Protection Bureau
- Elimination of the Office of Thrift Supervision
- Supervision by the Federal Reserve of certain non-bank financial institutions determined to be systemically important

The impact of this legislation is far-reaching. The Volcker Rule (which includes proprietary trading restrictions on financial institutions) will fundamentally change the way financial firms conduct business and influence where they choose to locate their trading activities. The repeal of Regulation Q will now allow corporations and other business entities to earn interest on demand deposit account balances for the first time since
the 1930s. There are important changes to FDIC deposit insurance included in Dodd-Frank as well. Deposit insurance has been increased permanently and, for some types of accounts, it has been extended temporarily to an unlimited amount. Also, the assessments that banks pay into the deposit insurance fund have been radically redesigned.

**FDIC INSURANCE INCREASE**

FDIC insurance coverage has been permanently increased to $250,000 for all deposit accounts. This change is applicable retroactively to January 1, 2008, with the effect of subsequently insuring some depositors who initially lost money in prior bank failures during the financial crisis.

Additionally, effective December 31, 2010, Dodd-Frank grants unlimited FDIC coverage on non-interest bearing transaction accounts and Interest on Lawyers Trust Accounts (IOLTAs).

In 2010, the FDIC provided unlimited FDIC coverage on non-interest-bearing transaction accounts for those financial institutions participating in the Transaction Account Guarantee Program (TAGP). Some financial institutions opted out of TAGP because of the cost (a special FDIC assessment specific to this program applied) and the view held by the largest banks that the improving economic environment made continued participation in this program, and the associated cost to depositors, unnecessary. Under Dodd-Frank, no special assessment from the FDIC will be charged, and the temporary unlimited FDIC coverage applies to all non-interest-bearing transaction accounts, regardless of prior opt-out decisions by financial institutions.

The obvious benefit of this action is improved safety of deposits for all bank customers. There is an extra advantage for those customers who have deposits above $250,000 in non-interest-bearing transaction accounts. This is most likely to benefit traditional business customers who have not been eligible for interest-bearing checking accounts but who keep relatively large sums in demand deposit accounts, which could not earn interest.

The not-so-obvious benefit accrues to smaller banks. Unlimited insurance will allow them to attract and retain larger business customers, helping to level the playing field with larger banking institutions. However, the provisions of Dodd-Frank providing unlimited coverage are currently set to expire on December 31, 2012. It will be interesting to watch the political landscape during the 2012 election year as to whether this program will expire or be further extended.

**Changes to assessment methodology**

Dodd-Frank also makes changes to the FDIC assessment methodology for deposit insurance premiums. In 2011, the assessment base changed from total domestic deposits to total assets less tangible equity. Rates charged to banks on net assets will vary from five to 35 bps, based on the FDIC’s judgment of the financial institution’s stability.

A recent study by Treasury Strategies Inc. indicates that the change in methodology for determining the assessment will disproportionately burden the largest banks – the five largest banks hold $2 in net assets for every $1 in domestic deposits. In addition, the FDIC has proposed a discretionary adjustment to each large financial institution’s deposit insurance scorecard (which is used in setting assessments) that could have an impact on the assessment paid.

These factors will create uncertainty as to how banks may pass FDIC charges on to clients (largely in the corporate business world, where pass-through is the norm). We believe that assessment costs passed through to bank customers will vary widely (both the absolute charge and the actual rate applied) until the banking industry reaches a market-clearing price for FDIC assessments based on competitive forces. Other consequences of the assessment change may include the opportunity for clients to negotiate bank fees while some banks may elect not to pass through the FDIC assessment directly, but build the assessment into the cost of services across multiple line item fees.
REPEAL OF REGULATION Q

Dodd-Frank repeals Regulation Q and thus removes the Depression-era rule that prohibits banks from paying interest on business demand deposit accounts. This repeal becomes effective on July 21, 2011. The implications of this change include additional short-term cash options, with the addition of interest on demand deposit accounts, the re-evaluation of sweep services and the potential for new checking account product development.

Industry surveys and research indicate that many banks intend to offer some form of interest-bearing checking product to corporate clients, including an account that both gives earnings credits and pays interest.

New product development among banks will ultimately benefit their customers in providing more robust options to manage both operating and reserve cash. Additionally, as the interest rate environment changes, opportunities to re-position this short-term cash will flourish.

Other considerations include the fact that balances shifted to checking accounts that pay interest will be insured only up to $250,000 and increased competition from financial institutions that have not traditionally been significant competitors for business deposits. Specific benefits of these changes are expected to include:

- Expansion of various core cash management options around a customer’s checking account
- Reduction of idle excess balances in disparate and hard to concentrate accounts
- Potential reduction in the importance of cash concentration from an investment perspective

MONEY MARKET FUND REFORM

Money market mutual funds (MMF) held in excess of $2.5 trillion in assets as of March 2011. This investment option has historically played a significant role as an intermediary between borrowers and lenders. The financial crisis in 2008 heightened awareness of fund-specific and systemic risks associated with money funds. The Reserve Primary Fund “broke the buck” in September 2008 and $347 billion moved out of prime money funds in one week. The end result was to spread contagion to other markets.

In response, the SEC issued several regulatory changes, effective May 2010, to reduce systemic risk while preserving the traditional structure of money market funds. These reforms focused on risk reduction, increased liquidity, stronger oversight and enhanced transparency to investors. The specific actions included:

- Tightened liquidity requirements such as requiring that taxable money market funds have at least 10% of their holdings in assets that can be converted to cash in one day, requiring that all money market funds (such as Treasuries of any duration and Agencies that mature in less than 60 days) have at least 30% of their holdings in assets that can be converted to cash within one week, and limiting illiquid securities to no more than 5% (down from 10%) of total assets
- Stricter constraints on credit quality and diversification of securities such as lowering the maximum that a fund may invest in second-tier securities from 5% of assets to 3%
- Reduction in the maximum weighted average maturity (WAM) to 60 days (from 90) and establishment of a maximum weighted average life (WAL) of 120 days (WAL is a newly disclosed method of calculating portfolio maturity)
- Requirement that money market funds designate at least four ratings agencies that may be used in determining the eligibility and status of a security
- Requirement to report to the SEC, on a monthly basis, detailed portfolio schedules and other pertinent information such as shadow net asset values (NAV)
Dodd-Frank imposes further regulations and safeguards to protect money fund investors. There may be more to come. There are several proposals still being considered by the SEC and other policymakers, such as allowing money fund NAV to float, creating private emergency liquidity facilities, establishing insurance for MMFs, and regulating stable-NAV MMFs as special purpose banks.

The impact of the current and proposed changes will be substantial. Certainly there will be lower fund yields and higher fund expenses. Also, the uncertainty concerning additional regulation will require careful watching over the near term. There are benefits as well; we should see reduced systemic risk and increased transparency.

**BASEL III AND OTHER CHALLENGES**

Additional reforms within the financial industry abound. Basel III, designed to enhance capital and liquidity requirements for the banking industry, will take years to implement and it will take even longer to assess its ultimate impact. Certain pre-crisis liquidity channels are no longer available, including Special Investment Vehicles (SIV), Auction Rate Securities (ARS), Collateralized Debt Obligations (CDO), and more. These changes will cause major shifts in where corporate liquidity is held and how it is valued.

The very real possibility exists that extensive re-intermediation of liquidity to banks will occur. Under regulatory changes such as those intended under Basel III, not all bank funding is created equal. Certain deposits will be more valuable to financial institutions based on their characteristics. Interest rates paid on these deposits will adjust depending on deposit demographics. Operating cash from relationship clients will be quite valuable, whereas “hot” money from clients with no relationship will be less attractive.

There are benefits of these changes. For example, regulatory changes to increase the amount and quality of capital should support long-term financial viability within the banking industry, ultimately instilling confidence and creating market liquidity. Liquidity keeps the doors open. Market confidence is critical when placing deposits in the bank. Lack of confidence initially increases the cost of funding for banks and eventually that funding goes away.
INTEREST RATE FORECAST

Cash investment strategies should and will change through the various rate environments. Shown above is a view of projected short-term interest rates over the next few years. Clearly there is an expectation that rates will return to more normal levels over time.

Improved confidence, accommodative monetary policy and improving credit conditions are needed to create momentum in the economic recovery. Once these factors are present, rates will return to more normal levels. Recently, the European Central Bank (ECB) increased its rate. There is an expectation that there will be more to come within the European Union in 2011. However, the Federal Reserve’s FOMC is not likely to start exiting from its very accommodative policy stance until the spring of 2012, initially by raising the Fed Funds target rate and then by selling Treasury securities from the Fed’s huge portfolio.
STRATEGIES TO OPTIMIZE SHORT-TERM CASH INVESTMENTS

Certain best practices, along with a thorough understanding of the new regulatory realities, can help you weather the changing interest rate landscape, whatever the timing. Financial institutions will be adjusting to new rules and positioning their products to meet the requirements of their constituents (customers and regulators). The opportunity to optimize your short-term cash will never be greater.

In the current interest rate environment, where rates are very low and liquidity is likely to be abundant, here are some strategies to consider:

- Revisit investment policies and current cash allocation to determine earnings and bank fee strategies. Ask, “What is the appropriate balance between earnings credit and a nominal return?”

- Consider earnings credit rate net of an institution’s FDIC assessment in order to compare other cash alternatives. Net earnings credit may provide a valuable alternative to other options.

- Sweep services will have limited usefulness for the passive investor unless the cash position is substantial.

- Bank money market deposit accounts may be an attractive alternative, given relative return, when compared with other instruments.

- Term investments carry additional risk, given the expectation that rates will rise. Carefully review any existing positions or potential investments in light of how they may react to changing rates.

- Attempt to leverage relationships to a greater degree to influence interest rates available from banks.
In a rising rate environment, consider exploring the following opportunities:

- Re-evaluate priority assignment of available cash products. Do returns in income-producing accounts take precedence over the unlimited insurance on non-interest bearing checking accounts available through 2012?
- Adjust checking balances to maximize return by understanding how much is needed in the account to cover fees.
- Consider new interest-bearing alternatives as financial institutions expand their checking product offerings.
- Attempt to leverage relationships to a greater degree to influence interest rates available from banks.
- Evaluate the benefits of sweep services if you prefer a passive, convenience-oriented approach.
- Position cash to benefit from rising rates with shorter maturities.
- Evaluate traditional money market instruments (Treasuries, Commercial Paper, Repurchase Agreements, etc.), as they may react quickly to the change in rates.

Once rates have risen to a more normal historical level and are expected to remain stable:

- Review investment style preferences. Is an active vs. passive position more in line with organizational needs? Does convenience outweigh yield when managing your cash position? Is the necessary expertise resident within your organization to actively manage your positions?
- Money market funds should be expected to produce competitive returns and offer diversification, liquidity, and professional management.
- Position your cash to benefit from higher rates by potentially using term maturity products and taking advantage of the traditional MMF lag.
- Attempt to leverage relationships to a greater degree to influence interest rates available from banks.
- Evaluate ECR fee offset against direct payment of interest.

For more ideas, insight and solutions to move your business forward, contact your treasury management officer or visit pnc.com/treasury