Liquidity Management Solutions: A Changing Landscape

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Executive Summary

There is a "new normal" in cash management. Banks and money market mutual funds are changing the way they treat deposits. If you are a steward of liquidity, you must get ahead of the perfect regulatory storm that may make traditional cash management and deposit strategies obsolete.

The Reason for Change

Cash management is key to any successful enterprise. Poor practices not only can cause a business to fail but also can prevent it from paying expenses, issuing dividends, or taking advantage of various growth opportunities.

Tried-and-true approaches may not work, because cash management is fundamentally different in the wake of the Crash of '08. Liquidity managers need to understand how banks must segregate their deposits and how money market funds are now defining their investors.

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You should not delay in analyzing your cash management methods to ensure your money is earning competitive rates in a convenient place where it is both safe and liquid.

Why Cash Management Is Different Today

Big banks used to be able to manage the cash needs of most high-net-worth individuals, family offices, and midsize corporations. However, the worldwide financial collapse of the banking system uncorked hundreds of completely different and complicated regulations that have turned into the most far-reaching overhaul of the financial sector since the 1930s. Wall Street is spending billions of dollars complying with the regulations stemming from Dodd-Frank and Basel III.

Among other things, Basel III rules will increase the capital and liquidity buffers that banks with assets greater than $50 billion must carry. The Liquidity Coverage Ratio will require these banks to have more than enough unencumbered, high-quality assets (that can be turned into cash within a day) to withstand 100 percent of their total net cash outflows over a 30-day stress scenario. These regulations are changing how banks classify deposits and will create a disparity in how banks define and treat their institutional clientele.

To meet these liquidity ratios, banks will lower debt and concentrate on more low-yield, less risky liquid assets. These changes in the way banks manage their balance sheet will have a profound effect on their customers. Big U.S. banks are increasing fees, turning away deposits, or pushing deposit relationships into unattractive alternatives such as illiquid term securities. The practical result is that the rules are forcing certain banks to examine their existing client relationships to determine how, or whether, those account relationships remain profitable.

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Old lines of credit are becoming difficult to maintain, and banks are raising their fees and borrowing rates while lowering the returns they offer. The final phase of implementation for Basel III is set for 2019. However, to ensure compliance with the rules, banks are already adopting the changes to reassure rating agencies and shareholders. Unfortunately, no one knows whether the most sweeping banking reform since the Great Depression will work. That uncertainty brings additional costs and risks, which will affect balance sheets already hurting in a slow economy where interest rates are scraping the bottom.

In addition to the ongoing reform within the banking sector, regulatory pressures are also closing in on the money market mutual fund industry.

Money market mutual funds were once logical destinations for deposit and cash management solutions. Over the past 40 years, institutional investors have parked trillions of dollars in these funds because they were considered safe and efficient. After Lehman Brothers declared bankruptcy in September 2008, one money market fund "broke the buck," causing institutional investors to stampede out of money market funds, virtually shutting down the short-term funding market. This caused more than two dozen money market funds to be rescued by their sponsors in order to avoid potentially falling below the constant value of $1 per share, according to the New York Federal Reserve analysis. Since then the SEC has been tightening risk and liquidity requirements.

On October 14, 2016 money market funds will be required to have stricter diversification and liquidity stress-testing measures in place that could potentially cause a major disruption in the liquidity cash management sector.

> Bottom line? Money market mutual funds may be an unappealing place to park cash.

On this date, prime and municipal institutional money market funds will no longer be permitted to price shares at a constant $1 net asset value. It is anticipated that this drastic change in institutional money fund pricing will force a significant asset shift into the short-term government and treasuries market, thereby causing returns to the investor to potentially be even lower than they are today. The new rules will also segregate institutional investors into distinct and separate money market fund investments.

Furthermore, in times of stress, money market funds could be forced to impose a liquidity fee of up to 2 percent – or temporarily suspend redemptions – if liquidity thresholds fall below certain weekly required levels.

Cash forecasting will become more difficult due to the daily fluctuating net asset value in money market funds. Withdrawals may become a taxable event, potentially resulting in capital gains or losses. Your IT expenses will no doubt be impacted as you adjust your treasury system to accommodate the fluctuating share price for short-term cash management investments. Bottom line? Money market mutual funds may be an unappealing place to park cash.

Conclusion

Banks with less than $50 billion in assets are not subject to the Basel III rules. Within this universe, cash managers should focus on banks that have a thriving loan portfolio and a strong appetite for deposit growth. By switching to money market accounts offered by such banks, you can have principal stability and convenience too, while capturing higher rates. Constant and significant regulatory revision is making big banks and money market funds unattractive. Using these vehicles is getting more expensive, while providing less-predictable returns. You can simplify your life by moving your cash portfolios to money market accounts at well-capitalized banks with less than $50 billion in assets. It will lighten the paper burden of the new regulations, eliminate uncertainty about returns, and maybe capture a higher yield on your cash portfolio.