As a result of the 2008 financial crisis, the Basel Committee on Banking Supervision (“BCBS”) has proposed standards to provide stability to the banking sector by implementing safeguards that are intended to make banks more resilient in a financial crisis. Specifically, the BCBS under Basel III has introduced, amongst other things, stricter capital requirements, leverage limitations and liquidity provisions.

Impact of Regulatory Reform / Liquidity Coverage Ratio

Compliance with new regulations has led banks to withdraw from, or change pricing for, accepting cash deposits from alternative asset managers (“AAMs”). In addition to Liquidity Coverage Ratio (“LCR”) guidelines, banks face increased costs relating to compliance activities (such as enhanced know your customer requirements) and SIPC. AAMs and private equity (“PE”) funds have been left in a position in which many banks are unwilling to hold their cash. Several banks have, in fact, exited the cash management business. This article seeks to provide some background on the current landscape, and highlight some of the solutions that are being presented. At the highest level, AAMs are being forced to either pay higher fees in the form of negative spreads on cash or to accept risks in Money Market funds and other products rather than holding cash at their prime brokers.

Background of the Rule

The Federal Reserve adopted the LCR in 2014. The LCR standard will apply in full to U.S. depository institutions and U.S. depository institution holding companies with greater than $250 billion in assets or $10 billion in international exposure. A modified LCR will apply to bank holding companies and savings and loan holding companies that maintain between $50 billion and $250 billion in assets and are not significantly engaged in insurance or commercial activities.

The LCR requires that these institutions hold enough High Quality Liquid Assets (“HQLA”) to withstand severe deposit outflows over a 30-day period. LCR, which focuses on the short end of a bank’s funding liability side (less than 30 days) aims to improve the banking sector's ability to absorb shocks arising from financial and economic stress.

\[
\text{Liquidity Coverage Ratio} \quad 100\% < \frac{\text{Total HQLA}}{\text{Net Cash Outflows over Stress Horizon}}
\]

Bank holding companies with more than $250 billion in consolidated assets, or more than $10 billion in on-balance sheet foreign exposure, are subject to the LCR in full with implementation beginning in
2015. Bank holding companies between $50 billion and $250 billion in assets are only required to meet a LCR ratio of 70% and begin implementation in 2016.

What is Changing

LCR has two parts: (i) HQLA, and (ii) total net outflows based on run-off factors applicable to bank liabilities. Basel III assigns run-off factors to different funding sources. Net outflow assumptions take into account the deposits purpose, and depositor type. Deposits can be wholesale or retail. Wholesale deposits (the category at issue for purposes of this analysis) are divided into operational and non-operational sub-categories. Regulators now require that all deposits from non-regulated institutions including investment advisors, investment companies and non-regulated funds are considered non-operational in nature. Operational deposits are subject to a 25% runoff factor. Non-operational deposits are subject to a 100% runoff factor. The regulations assume a 100% run off for all AAM and PE deposits.

What Does it Mean

Unfortunately for AAMs and PEs, for deposits considered non-operational in nature the incoming cash is considered “fast outflow money” subject to withdrawal from the banks in the event of a liquidity crisis. As a result, banks are required to hold liquid assets against the cash, which has a cost associated with it. This cost needs to be mitigated by either moving the cash off of the bank’s balance sheet or with appropriate fees. This means that for every $1 in finance-related deposits a bank holds, it will be required to hold $1 in HQLA. In this new regime, banks are required to put aside additional lower yielding HQLA in order to support deposits from alternative asset managers. Holding a higher balance of lower yielding HQLAs to cover these liabilities adversely impacts profits and may drive prime brokers to re-evaluate the overall relationship and their ability to finance certain client portfolios to ensure that they are holding an adequate ratio of unencumbered HQLA.

How are Banks and AAMs/PEs Responding?

Wells Fargo Securities’ Fixed Income market and Portfolio Strategy Analyst, Garret Sloan, anecdotally describes a range of responses from AAMs and PEs on what to do with their cash. On one extreme, an AAM invests its cash in its own high yield fixed income fund. On the other end of the spectrum, an AAM invests only in Treasury Money Market funds and will not consider Prime Funds or any deposit product, as it is unwilling to accept additional exposure to a bank counterparty. Asset management companies are offering Money Market funds and other cash investment vehicles as alternatives to cash deposits. Bank deposits are still an option available to AAMs; however, banks have started passing LCR costs on to clients and are generally not offering a spread on balances. Banks are also offering money market sweeps as an alternative to holding deposits on balance sheet. Wells Fargo Securities expects the trend of moving cash off bank balance sheets into Money Market funds and other investments to increase going forward. Additionally, Wells Fargo Securities expects banks to continue passing on the LCR and increased operational expenses to AAM clients. Having a holistic relationship with a bank will be paramount.

What Does the Landscape Look Like Now and in the Future?

The effects of the regulatory climate will continue to change the way AAMs and prime brokers interact. Prime brokers may push out all cash accounts and / or sweep cash into money market accounts. Banks have to consider return on assets (“ROA”) in addition to return on equity (“ROE”). With leverage ratios as a constraining factor, banks may need to stop doing business with clients that are not meeting ROA hurdles. AAMs, in turn, will need to better understand their holistic relationship with an organization, considering all elements of wallet share – including non-capital/balance sheet
consumptive services such as custody and fund administration as well as execution. Following the financial crisis in 2008, several AAMs sought to diversify their prime brokerage relationships and banking counterparties to avoid a situation where cash was concentrated among a few counterparties. In contrast, today we expect that AAMs will reevaluate prime brokerage relationships more holistically, and potentially reduce the number of counterparties they face in order to be a more meaningful component of wallet-share. Banking institutions like Wells Fargo that provide a full range of services may be the natural winners as AAMs recognize the need to concentrate wallet share. Banks with healthy balance sheets are able to take on AAM banking accounts as part of a holistic relationship. Increasingly, prime brokers that have cash management capabilities may see more partnerships as AAMs recognize the need to be relevant to banking institutions as a whole.