A defining moment
New regulations and their impact on the definition of cash deposits
It’s a defining moment for companies and their banks in the post-financial crisis world.

New regulations are changing how cash deposits are classified, which will create a disparity in how banks and companies define that cash. And while the full impact has yet to be realized, the new rules will profoundly affect both sides of the partnership. Banks will be required to change how they manage their balance sheets, and companies will need to consider how they manage their banking relationships.

Importantly, there will be strict definitions for operating and non-operating deposits. And the regulations, not the bank or the company, will determine how deposits are classified, directly affecting the value of the deposits.

As the regulations phase-in over the next few years, several things are likely. First, it’s expected that companies with large transactional flows and high volumes that use multiple bank products will have a higher percentage of their deposits classified as operating. Next, companies with limited flows, large spikes in balances and limited product usage will see more of their deposits designated as non-operating, and bank appetite for these deposits will be limited given lower expected returns and increased costs. Finally, there will be increased market pressure on larger banks to conform now to the new regulations.

Given this new reality, companies will want to consider:

• How their cash management business is currently distributed across banking relationships, and whether their deposits are supporting transactional flows.

• Speaking with banking partners about solutions to optimize the cash that is needed to fund payments and increase their efficiency ratio, and alternatives for non-operating deposits, such as money market funds, repo and commercial paper.

• Determining whether current investment policies support the anticipated changes for non-operating deposits.
The company and bank view of cash

Historically the company’s and the bank’s definitions of operating cash aligned.

For companies of all types, operating cash has been traditionally defined as cash in deposit accounts used to meet payment and financial obligations. It’s comprised of both collections flowing through the account and additional cash on hand as a buffer to ensure payments are funded.

For banks, the trillions of dollars in daily flows into and out of client deposit accounts have been treated as a portfolio of operating cash and used as a stable and reliable source of funding for loans and other bank products. Banks earned a profit on the spread between the cost of funds (the payout to companies for all cash deposits) and the return on funds (the charge borrowers incur for use of a typical term loan), producing significant bottom line value.

But that definition is about to change.

The new regulatory view

After the 2008 financial crisis, a primary goal of regulators was to ensure that banks could meet their liquidity needs in a stressed environment. To achieve this, regulators reviewed bank funding sources to evaluate reliability under stress.

When reviewing cash in deposit accounts, the regulators determined that only the cash required to fund a company’s upcoming payments would be likely to remain on deposit during a time of stress. They defined these deposits as operating. They also believed that cash held in deposit accounts in excess of operating deposits would become scarce during a stress event and therefore couldn’t be relied upon during an isolated bank stress event. These deposits are defined as non-operating and classified as short-term wholesale funding (STWF).

What it boils down to is that the regulators now require banks to establish and be able to justify quantitative measures that classify deposits as operating or non-operating, or reliable funding versus less reliable funding. It is no longer about qualitative measures or how companies view their cash or how the cash has behaved historically—it is all about quantification and substantiation.

A new view on operating cash

<table>
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<tr>
<th>Basel I &amp; II reforms were focused on bank assets</th>
<th>Operating cash under Basel I &amp; II:</th>
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<td>Defined loosely by banks, and could include any cash received from a depositor.</td>
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<th>Basel III reforms are focused on bank liabilities</th>
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<td>More strictly defined. Banks need to quantitatively substantiate to the regulators the relationship of the client’s deposits to the client’s use of transaction activity with the bank.</td>
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New definition of operating deposits

Operating Cash

REGULATORY DEFINITION

Operating Deposits

Non-Operating Deposits

SHORT-TERM WHOLESALE FUNDING
Going forward

Deposits that meet the established regulatory criteria for operating deposits can continue to be used by banks to fund loans and other bank products and will continue to earn the spread that makes operating cash attractive for banks.

To ensure the availability of liquidity for STWF in a time of stress, including non-operating deposits, the regulators now require that a significant portion of those liabilities be covered by High Quality Liquid Assets (HQLA) (e.g., Treasuries and placements at select central banks). HQLA provide security, liquidity and reliability in a stress event, but those benefits come at a price, notably limited and potentially negative returns. When compared to the return potential for operating deposits used to fund loans, the return on non-operating deposits deployed against HQLA is significantly less, limiting return potential for both the bank and the company.

Leverage ratio and Global Systemically Important Banks (GSIB)

Limited return is not ideal, but it’s still return. However, the costs associated with holding non-operating deposits don’t stop with HQLA. Regulators have put further pressure and costs on STWF—non-operating deposits— with the addition of the leverage ratio and GSIB assessment.

### Basel III: U.S. application of GSIB

| Non-operating balances will increase the U.S. GSIB score, which results in increased capital costs for a bank |
|---|---|
| **GSIB Criteria** | **Cash Management Relevance** |
| SIZE | Total Deposits |
| INTERCONNECTEDNESS | Deposits held in accounts of bank clients |
| COMPLEXITY | Indirectly relevant |
| CROSS-JURISDICTIONAL ACTIVITY | Deposits held by non-US entities, or booked in non-U.S. branches |
| SHORT-TERM WHOLESALE FUNDING | Includes non-operating balances (U.S. only) |

The leverage ratio

Every liability (e.g., non-operating deposits) generates an asset (e.g., HQLA) that requires capital. The leverage ratio establishes that for any given amount of capital, there is a finite amount of assets it can support, regardless of the credit quality. As a bank approaches its leverage ratio, it has to weigh the cost of additional capital against the potential return on an asset, and whether that return is sufficient to meet shareholder return-on-capital expectations. While the typical return on operating deposits is sufficient to support the cost of capital, non-operating deposits are unlikely to come close to supporting market-comparable return levels even in the best interest rate environment.

Global Systemically Important Banks

For the largest banks, the capital return challenge is magnified by the rules outlined for GSIB. The GSIB assessment assigns a specific score to each bank based on its potential to disrupt the market in an isolated stress event. The higher the GSIB score, the greater the amount of capital a bank must hold for a given level of assets.

One of the most significant determinants of the U.S. GSIB score is the amount of STWF—including non-operating deposits—held by the bank. In the best-case scenario GSIB adds a significant additional cost. However, if a bank seeks to reduce its capital requirement by lowering its GSIB score, it may become impossible to justify holding any non-operating deposits.

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**Examples of HQLA under Basel III**

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<th>Level</th>
<th>HQLA Description</th>
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<tbody>
<tr>
<td>Level 1</td>
<td>Cash, central bank reserves, central bank assets, sovereign debt</td>
</tr>
<tr>
<td>Level 2A</td>
<td>Government securities, covered bonds, corporate debt securities</td>
</tr>
<tr>
<td>Level 2B</td>
<td>RMBS rated AA or higher, corporate or covered bonds rated A+ to BBB, corporate equity securities</td>
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Non-operating deposits are increasingly less attractive to banks because of the regulation’s requirements to match against HQLA and the associated capital costs.

Holding more HQLA reduces a bank’s ability to invest in longer-term, higher yielding assets.

As a result of decreased return and increased costs, banks are likely to drive client non-operating deposits to off balance sheet alternatives.

Under Basel III, clients may need to find alternative vehicles for non-operating cash

The definition of deposits has changed—the regulations, not the bank or the company, now classify cash deposits as either operating or non-operating.

Operating deposits require quantitative substantiation of their use to support transactional activity—everything else is non-operating.

For a company, both the return on and the bank’s appetite for their cash will depend greatly on the classification.

For a bank, the benefits of non-operating deposits are unlikely to cover the associated costs, and it is expected that the market will see a significant decrease in a bank’s ability to hold non-operating deposits on balance sheet.

In this new regulatory world, both companies and their banks will need to explore alternative placements for non-operating deposits.

Now is the time to assess how best to manage these changes and work with your banking partner to explore ways to optimize your cash.

To discuss this issue further, contact your J.P. Morgan relationship manager.
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Phillip Lindow is responsible for all aspects of the Liquidity business globally within J.P. Morgan’s Corporate & Investment Bank, including business strategy, product management, solutions development and sales. The business serves clients across all segments and regions.

Before joining J.P. Morgan, Phillip was head of the International Liquidity & Investment Management business for the Royal Bank of Scotland. In that role, he directed product management and strategy for liquidity management services and transactional FX/Netting, and managed investment advisory services for the bank’s clients.

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During his 20 year career in financial services, Phillip has also served as Managing Director and Head of Global Treasury and Investment Management in the Transaction Banking Business unit of ABN AMRO, and has held various management roles at Chase Manhattan Bank, Deutsche Bank and its predecessor Banker’s Trust.

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