TREASURY MANAGEMENT

BANK REGULATION AND YOUR BUSINESS

LIQUIDITY COVERAGE RATIO (LCR)

The Liquidity Coverage Ratio (LCR) was created by banking regulators to enhance the banking industry's ability to absorb shocks resulting from financial and economic stress and to strengthen the industry's processes for monitoring and managing liquidity. Over the long term, the LCR rule will benefit your business by increasing the strength of the banking industry.

THE LCR RULE

- Requires a banking organization to maintain a minimum amount of liquid assets to withstand a 30-day standardized stress scenario,
- Prescribes what types of assets a banking organization must hold to maintain its liquidity buffer; and,
- Specifies the uses of and needs for liquidity (for example, deposit outflows and commitment utilization)

Expected inflow and outflow rates for specific product, customer and transaction types are predetermined by the rule and standardized for covered banking organizations based on recent liquidity and financial industry stress experiences.

> Even though the LCR is targeted at the banks themselves and not directly at their customers, your banking relationships — and as a result your business — may be affected as banks begin to integrate LCR impacts into their business and risk management practices.

LCR REQUIREMENTS VARY BY BANK SIZE

The LCR requirements differ across banks of varying size. In addition, requirements may also differ based on jurisdiction and geographic location of the institution (e.g., rules in Canada or Europe may differ from those in the U.S.).

There are three basic levels of required compliance under the U.S. LCR rules based on the total assets of the bank:

Full LCR (greater than $250B in assets)
- Subject to LCR requirements without any adjustments

Modified LCR ($50B–$250B in assets)
- Outflow requirements are reduced by 30% to decrease the burden of compliance

Not subject to LCR (less than $50B in assets)

WILL LCR IMPACT BANKING RELATIONSHIPS?

Specific customer impacts as a result of LCR are challenging to predict, but it is not likely that there will be a dramatic shift. Even though the LCR is targeted at the banks themselves and not directly at their customers, your banking relationships — and as a result your business — may be affected as banks begin to integrate LCR impacts into their business and risk management practices.

Ultimately the impact will depend on a wide array of factors, including:

- **Are you considered a "financial sector entity"?** The LCR assigns higher outflow rates for loans and deposits for financial sector entities. Financial sector entities include: Investment Advisers, Investment Companies, Pension Funds, Non-Regulated Funds and other regulated financial companies.
- **What products do you use?** The LCR views certain bank products and credit structures more favorably than others. For example, deposits from a customer who utilizes the bank's cash management services to operate its business are often treated more favorably than deposits from a similar customer who does not use these types of products and services. Another example is that the LCR treats credit facilities more favorably than liquidity facilities.
- **What portion of your loan borrowings are unfunded?** Under the LCR Final Rule, customers are assumed to utilize a portion or, in some cases, 100% of any unfunded loan commitment that is provided to them by the bank, resulting in a requirement to recognize an LCR outflow.
  - Outflow rates for undrawn commitments are differentiated based upon customer type, product and structure, with outflow rates ranging from 10% to 100%.
- **Relationship matters!** Banks will place a greater value on broad, multi-service relationships.
  - Since the LCR requires banks to maintain a sufficient amount of high-quality liquid assets to withstand outflows, banks will be more likely to rationalize and re-price the credit they provide to customers or make up the cost differential through additional cross-sell.

WILL LCR LEAD TO NEW BANK PRODUCTS?

Banks will likely attempt to create new products or structures to minimize adverse LCR treatment under the LCR. Your business may benefit by taking advantage of newly created "LCR friendly" products that banks will be eager to provide, such as:

- Term deposit products which may include callable Certificates of Deposit (CD) or CDs with maturity acceleration options.
- Aggregated deposits beneficially owned by consumers that are eligible for pass-through FDIC insurance (Health Savings Accounts, for example).
- Deposit products that qualify as favorable operational deposits under the rule.

HOW WILL BANKS VIEW MY DEPOSITS?

In general, the LCR will strengthen a bank's appetite for deposits. Deposits are a bank's most critical source of funding and will become increasingly important. However, not all deposits are treated equally. The ultimate LCR value of a deposit will be determined by a number of factors, including:

- Customer type
- Deposit insurance (FDIC coverage)
- Purpose and usage of funds (operational vs. investment)
- Collateralized vs. uncollateralized
- Deposit term (does not apply to outflow rates assigned to deposits from individuals and certain small businesses)
- Source and ownership of funds

DEPOSITS THAT WILL BE LCR FRIENDLY

- Retail deposits (individuals and certain small businesses) which are fully insured by the FDIC
- Deposits placed at a bank by a third party in which the beneficial owners of the funds are individuals which are fully insured by the FDIC
- Deposits that support a customer's usage of operational services
- Escrow deposits
- Term deposits from wholesale counterparties
- Brokered deposits from retail counterparties

DEPOSITS THAT ARE LESS LCR FRIENDLY

- Collateralized deposits, because the securities pledged as collateral can no longer count as high-quality liquid assets to meet the LCR
- Balances subject to repurchase agreements
- Deposits from financial sector entities that are not critical to supporting the operations of the business, including excess or investment funds
- Any deposit from a non-regulated fund

OTHER IMPACTS

- **Debt issuance:** Most corporate or municipal issuances will not be eligible for consideration as a high-quality liquid asset for the purposes of LCR. As a result, demand for such issuances from banks may decline, resulting in increased rates/costs.
- **Changes to agreements for specific banking services:** Changes may be minor and non-impactful, but banks will likely revise certain deposit product and credit agreements to ensure accurate LCR treatment.

Over the long term, the LCR rule will benefit your business by increasing the strength of the banking industry.

READY TO HELP

At PNC, we combine a wider range of financial resources with a deeper understanding of your business to help you achieve your goals. To learn more about how we can bring ideas, insight and solutions to you, please contact your Relationship Manager or visit **pnc.com/ideas**.

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