

# Regulatory Reform Update: Basel III, Dodd-Frank and Their Impact on Banks and Their Clients



**BY MICHAEL BERKOWITZ**

Head of North America Liquidity,  
Investments and Information Services,  
Global Transaction Services, Citi

In response to the financial crisis that began in 2008, the Basel Committee on Banking Supervision has revised the Basel Accords on financial regulation to strengthen capital requirements and liquidity standards for banks and other financial institutions. Basel III's provisions are designed to achieve two goals:

1. Raise the quality, consistency and transparency of the industry's regulatory capital base
2. Strengthen supervision of liquidity risk

The implications are profound both for banks and their clients.

## Driving up credit costs

By requiring banks to employ common shares and retained earnings—commonly referred to as Tier 1 capital—as their predominant form of regulatory capital, banks will face higher capital costs. This capital quality requirement is likely to lead to more industry consolidation and an even higher cost of entry for smaller banks.

For banks' clients, the reforms—at least as currently proposed—will lead to higher credit costs, forcing many corporations to limit their appetites for external funding and increase their focus on preservation of capital. Companies operating in emerging markets may feel the credit contraction more severely as the higher cost of goods sold gets passed through their supply chain.

## New liquidity standards

Basel III introduces two key liquidity ratios intended to strengthen the supervision of liquidity risk. The Liquidity Coverage Ratio, a short-term liquidity

indicator, is designed to ensure that banks maintain adequate unencumbered, high-quality liquid assets that can be converted to cash to meet liquidity needs for a 30-day time horizon. The other ratio, the Net Stable Funding Ratio, establishes a minimum acceptable amount of stable funding based on the liquidity characteristics of an institution's assets and activities over a 12-month time horizon.

For banks, these new ratios will pressure revenue and margins. Internal bank transfer pricing for deposits will evolve to reflect varying deposit valuations and competition will stiffen for non- and low-interest-bearing deposits. Clients with "less desirable" types of deposits may see higher fees as a result.

## Basel III: Room for improvement

Basel III reforms will make the banking system safer. However, there is still plenty of room for improvement. For example, some international regulators are imposing double-digit capital ratios that will dampen banks' willingness to lend. What's more, the reforms do little to reign in the regulators in countries that have historically created arbitrage opportunities by failing to enforce international rules uniformly.

The good news is that Basel III regulations have yet to be finalized, so there are still opportunities for the parties and countries involved to fine tune them to create a stronger, more resilient financial services sector.

## Dodd-Frank update

The Dodd-Frank Wall Street Reform and Consumer Protection Act—signed

into law last year—also includes several changes of interest to corporate finance executives. Dodd-Frank makes permanent the FDIC maximum insured amount of USD250,000 per depositor per bank. It also provides unlimited insurance protection on non-interest-bearing transaction accounts until the end of next year.

For companies that allocate a large portion of their portfolio to low-yielding government instruments, unlimited FDIC insurance provides welcome flexibility. The measure also expands the FDIC assessment base to banks' global liabilities/net assets and thereby has reduced, at least for the near term, the Fed Funds Effective and Overnight LIBOR rates.

Effective July 2011, Dodd-Frank also repeals Regulation Q, which prohibited banks from paying interest on corporate checking accounts. This provides more flexibility for companies that cannot sweep funds offshore for regulatory or investment policy reasons, as well as those working with banks that do not offer investment options such as time deposits and money market funds.

## Stay tuned for more updates

It is still too soon to assess the full impact of Dodd-Frank and Basel III. Many rules have yet to be defined or fully implemented. Therefore, financial institutions and their clients need to stay tuned and to develop flexible strategic plans for responding to new and future changes.