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Liquidity Transfer Pricing: a Channel Island Perspective

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Liquidity Transfer Pricing (LTP) is a term that was perhaps not part of mainstream banking language prior to the global financial crisis in 2007.

Prior to the crisis, many banks lacked liquidity policies that were sufficiently backed up by a formal process to attribute liquidity costs to assets and, conversely, liquidity credits to liabilities between business activities.

For Governments and regulators, this was one of the key lessons learnt from the global financial crisis. As a consequence, they have since set out to ensure that banks are now required to maintain sufficient sources of funding to meet the demands of their business activities – through a global, voluntary regulatory standard known as Basel III, being introduced from this year.

Deposits are an important source of funding for many banks. Under the new proposals, business areas responsible for raising retail deposits, and in some cases wholesale deposits, would be credited for the benefit of the liquidity that they provide. This has the potential to be highly pertinent to the financial services industry in the Channel Islands, in terms of the profitability of local deposit takers - the banks - and the impact on the providers of their liquidity, such as trust companies and other financial intermediaries.

Basel III – a new approach

This new regulation starts to address how deposits should be categorised. Deposits, which internally are termed as ‘sticky’ or ‘hot/volatile’, are assessed and if appropriate will receive ‘credits’ based upon their likelihood of being withdrawn.

As a general rule, sticky money, such as term deposits, are less likely to be withdrawn and should therefore receive larger ‘credits’ than hot/volatile money, such as demand deposits, savings and transaction accounts, which are more likely to be withdrawn at any time.

If however, all similar demand accounts were collectively considered and the behaviour of cash flows modelled over time, there would be a ‘stable’ proportion that is rarely withdrawn and a ‘hot or volatile’ proportion that is withdrawn more often. Making this distinction is important, because if a bank was to simply apply a ‘matched-maturity marginal cost of funding’ approach, all demand deposits would only receive a credit based on the overnight term liquidity premium.

In addition to cash flow modelling, when determining stickiness, banks may also consider the type of entity, the type of cash products, the breadth of relationship to additional products, and the decision making process relating to cash holdings.

In terms of the entity type, the following five categories, listed from least to most sticky, help illustrate how different funding sources may be viewed:

1) Wholesale: Proper wholesale money and cash funds where investment managers make the decisions. If instant access savings or short-term deposits then zero liquidity credit would be applied,

2) Pool structures
    i) Discretionary: operated under a fully discretionary mandate, where the investment manager makes decisions,
    ii) Client: where the client is the decision maker for over 50% of decisions. Typically a diversified decision making process where the brokers publish rates and the client speaks to the broker to make the decision,

3) Fund entities: such as private equity and real estate funds. Cash is a by-product of these activities and therefore may sit for a long period as cash un-invested between investments,

4) Trust world: such as a relationship with a corporate trustee where there are many different bank accounts that they administer. Whilst not legally managed by the client, the end client has at least partial control over their funds. There can be multiple responses and decision making processes by clients in the event of a crisis situation,

5) Designated accounts: clients are entrenched with the Bank, for example being tied into payment systems and electronic banking. Clients will often hold other products, such as loans.

This graduation is reflected in Basel III as the difference between Institutional (type 1) and Retail.

Impact

How direct relationships are between the bank, its clients and the ultimate 'decision makers' will be absolutely key in this new world of Basel III. The type of relationship an intermediary has with its bank together with the complexity of that relationship potentially will have a major impact on the value attributed by the bank to that intermediary's deposits placed with it.

Banks are likely to put a higher value on relationships with clients and intermediaries that are well established, and where clients are well embedded with the bank through their use of other products and services that are provided by the bank.

These changes may impact the cash pooling providers who have been attractive in the last few years. Their models relied on being able to pool money from many different intermediaries and their clients to improve returns. The changes arising from Basel III will place parts of this business model under stress as pooled money will be unattractive to banks' treasury teams.

The potential impact of liquidity credits is important to the financial services industry in the Channel Islands as it offers up the possibility for additional remuneration based upon the perceived value attached to source of funds by internal treasury units. To illustrate this point, if 50% of the deposit base of Jersey (£155bn) was internally categorised as 'trust and retail' deposits which went on to receive an annualised liquidity credit of 40 basis points this would produce a lift of £310m in overall revenue for banks in Jersey annually.

As a result of Basel III and the increased importance it places on the relationships banks have with clients and intermediaries, it is likely that 'old fashioned' relationship banking operated via designated bank accounts will become increasingly popular. At Deutsche Bank we are taking these potential changes seriously and are working in a number of different forums to ensure that the impact of these changes is understood and that we achieve the best outcomes for clients. This is especially important for Jersey and its fiduciary business which rely on a competitive and supportive bank sector.

Ends.