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INSIGHT FOR FINANCIAL INSTITUTIONS

COMMERCIAL BANKING

The liquidity challenge

The liquidity challenge for the wealth management sector

June 2017

For your next step

LLOYDS BANK

Executive summary

- The appeal of short-dated / volatile deposits for banks has significantly reduced as a result of new prudential liquidity standards, including the Basel III Liquidity Coverage Ratio.
- Under recently introduced FCA client money rules, stockbrokers and wealth managers, who collectively manage approximately £700bn of the UK's wealth, are no longer permitted to place Client Assets Sourcebook (CASS 7) client monies on unbreakable fixed term deposits beyond 30 days.
- Consequently, CASS 7 deposits from wealth management firms have become less attractive to banks as they do not contribute to a bank's funding position.
- Due to lack of appetite from banks, some wealth management firms are experiencing difficulty in adhering to their own risk management policies around concentration risk, designed to protect their underlying clients from being overly exposed to the risk of single bank failure.
- Lloyds Bank believes that the industry and the FCA need to work together to consider and develop solutions that will alleviate current pressures in finding a safe home for client cash, while improving the attractiveness of such deposits to banks. Examples might include:
  - Extending the FCA's unbreakable fixed term deposit rule beyond the current 30-day restriction
  - Considering the development of new products that deliver the same, or increased, level of client protection while allowing banks to treat the deposits differently from a balance sheet perspective.

Introduction

Since the global financial crisis, liquidity risk has received greater attention and scrutiny from regulators, financial institutions and corporate treasury practitioners alike.

The resulting changes in guidance, policy and practice have altered both bank operating models and changed relationships between corporates and their banking partners. Today, banks appear to have varying appetite for client deposits and we have seen clear evidence of deposits being refused by banks and clients being asked to remove balances.

Regulatory change

After the banking crisis, the appeal of short-term or volatile deposits for banks has been significantly reduced as a result of regulation aimed at strengthening bank liquidity standards.

First, in 2009, came the UK's Individual Liquidity Adequacy Standards (ILAS) regime. More recently, through CRD IV, the European implementation of Basel III, we have seen the advent of the Liquidity Coverage Ratio (LCR).

Under LCR, banks need to hold sufficient 'high quality liquid assets' to cover at least a 30-day idiosyncratic or market stress event as part of the strengthening of their liquidity risk management framework. The LCR gives non-bank financial institutions cash less favourable liquidity treatment than that received for corporate cash in terms of outflow rates. Where the former attracts a 100% outflow rate on non-operational balances, non-operational corporate cash only has a 40% outflow rate. Given this treatment, unless institutional clients can place their cash beyond the 30-day window, such short dated deposits have since become unattractive to banks.

Arguably, the sector now facing the most significant challenge is the wealth and stockbroking industry, which looks after over £700bn of the UK's wealth, and plays a vital role in the nation's economy.

Client deposits emanating from the sector are subject to additional rigorous regulation under the FCA's Client Assets Sourcebook (CASS) regime. As noted above, under LCR, monies placed on notice for less than 30 days are subject to a 100% outflow treatment. Yet, under the FCA's client money rules that came into effect starting from July 2014, wealth management firms are no longer permitted to place client monies on unbreakable fixed term deposits beyond 30 days.

The sector now facing the most significant challenge is the wealth and stockbroking industry, which looks after over £700bn of the UK's wealth, and plays a vital role in the nation's economy

Consequently, the new liquidity risk management framework results in deposits by wealth managers becoming less attractive to banks, as they do not represent or contribute to a bank's funding position.

The situation has become even more challenging in recent months against the backdrop of significant levels of liquidity in the market, resulting in part from quantitative easing programmes and initiatives such as the Term Funding Scheme (TFS). In fact, there is clear evidence of banks now refusing to accept CASS 7 client deposits and in some cases asking for these deposits to be removed.

Wealth management firms have expressed concern in adhering to their own risk management policies around concentration risk which are designed to protect their underlying clients from being overly exposed to the risk of single bank failure. An additional risk is the lack of appetite for deposit-taking among UK banks forcing wealth managers to direct deposits towards non-UK banks which may result in firms taking on additional counterparty risk.

There is little doubt that the current and forthcoming regulatory and economic environment has changed bank operating models, leading to a change of focus between wealth management firms and their banking partners. Wealth managers are increasingly recognising that discussions with their banking partners around client deposits can no longer be centred on return (or in some cases safety), instead, the focus is on available capacity to accept the deposits in the first place, given the limited liquidity value on offer.

A situation has now arisen whereby a bank is required to assess its capacity to take on deposits, adopting a rigorous review to providing balance sheet capacity on what is now considered to be a scarce resource.

Facing the future together

Lloyds Bank has actively supported discussions with the FCA to heighten awareness of the problem and to seek workable solutions.

We believe it needs to be recognised that the current surplus of liquidity in the market is having a detrimental impact on banks' appetite to accept deposits from the wealth management sector, given the required regulatory liquidity treatment on such monies.

At Lloyds Bank, through our Financial Institutions coverage team, we have raised this matter directly with the Wealth Management Association (WMA) and other industry trade bodies. More generally, Lloyds Bank has actively supported discussions with the FCA to heighten awareness of the problem and to seek workable solutions.

While no expectations have been set, we remain hopeful that the removal of the current 30-day client monies rule may be considered. And should the FCA decide to replace or extend this timeline beyond 30 days, that would certainly assist in the short-term in addressing immediate capacity constraints. We do not, however, necessarily believe that this is the complete solution needed by the industry, or indeed the banks that service the sector.

The impact of the above undoubtedly presents a huge challenge to the wealth sector and we believe that, as a consequence, firms may need to seriously assess the suitability of alternative products and structures. It seems, to us, that the answer lies not with one solution but with a collaborative approach and the industry must take the opportunity to consider what products might need to be made available to cater for future requirements.

Since 2015, Lloyds Bank has supported the sector to meet this challenge. For example, we were one of the first banks to offer a 30-day notice deposit account for wealth management firms.

Next steps

We fully appreciate the FCA's main objective behind the introduction of the 30-day restriction, since the aim of this particular rule was to ensure that client monies were returned for timely distribution in the event of insolvency. Nevertheless, it would appear that, in practical terms, the extension of the 30-day rule would not have any significant adverse impact on the distribution timeframe should it be agreed to extend the rule to for example, a 95 day period.

The previously employed liquidity frameworks under ILAS permitted a benchmark stress event period of three calendar months. If the wealth management industry were permitted to place deposits up to 95 days, we believe that this would allow such deposits to become more attractive to banks, at least in the short-term, particularly if held on 95 days' notice.

We have been proactively working with a number of our key clients to explore the suitability of alternative structures to alleviate the pressures being seen around lack of capacity in the market for client deposits. We recently held a workshop involving a number of clients together with the WMA to collectively consider what other products may be available for use and how these might operate within the regulatory confines of CASS.

A wide range of possibilities were considered, including the potential formation of a 'wealth sector' bank whose sole purpose would be to accept deposits which could be then be placed with the Bank of England. Provision of pre-approved credit facilities for daily liquidity needs was also discussed, alongside considering other financial instruments more readily available, such as Money Market Funds. However, each presents a different set of challenges.

Collateralised Deposit arrangement

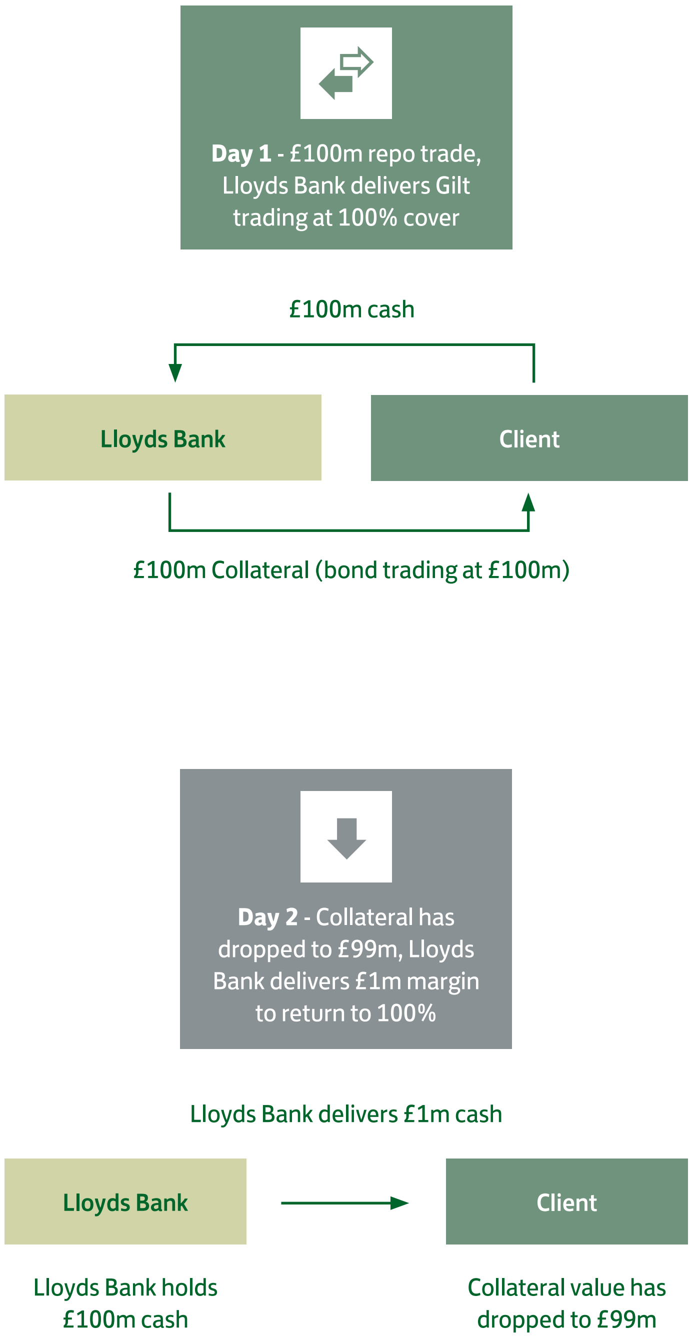
An example of one product that warrants further consideration is the use of 'Collateralised Deposit' type arrangements, with which to hold client monies.

Under such an arrangement, Lloyds Bank uses the option of providing a repurchase agreement or 'repo' whereby we accept client cash from a wealth management firm in exchange for UK Government gilts on a secured basis. It is proposed that Lloyds Bank would agree to sell and buyback this collateral at the same value and pay interest on the cash borrowed.

If the value of the collateral changes during the term of the repo, margin calls would be made via CREST to ensure that both parties retain sufficient security to ensure that the value of the collateral is always equal to the cash value of the repo.

It is somewhat ironic that, at present, regulation is preventing wealth management firms from considering such alternatives, notwithstanding that they offer a more secure environment for client monies than traditional bank accounts. Under both products, any depositor would rank as an unsecured creditor in the event of Bank insolvency, however, a cash deposit is only secured to the value of £85,000 under the Financial Services Compensation Scheme, whereas using the Collateralised Deposit option, the value of the deposit would always be fully secured, given the collateral arrangements to be employed.

In addition, we must also consider the likely impacts surrounding bank ring-fencing and what this might mean for the wealth management sector – in other words, which products and services can be maintained within the ring-fenced bank and which cannot.



In conclusion

As we head further into 2017, we do see some clients starting to be afforded a degree of capacity from other banks beginning to take cash again. A word of caution however: as banks approach key reporting periods, will they look to retain or push away? Evidence from the last few months would firmly suggest the latter. Little has changed, the issue of a lack of capacity hasn’t gone away and we would suggest it is likely to manifest itself again with greater intensity as the year progresses.

Given the challenges outlined, it is important that firms work closely with their banks to understand their deposit appetite. We need to work together to future-proof banks’ support for the sector, rather than rely on past experiences.

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