



# Financial Regulatory Reform and its Impact on Corporate Liquidity

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# The Big Picture

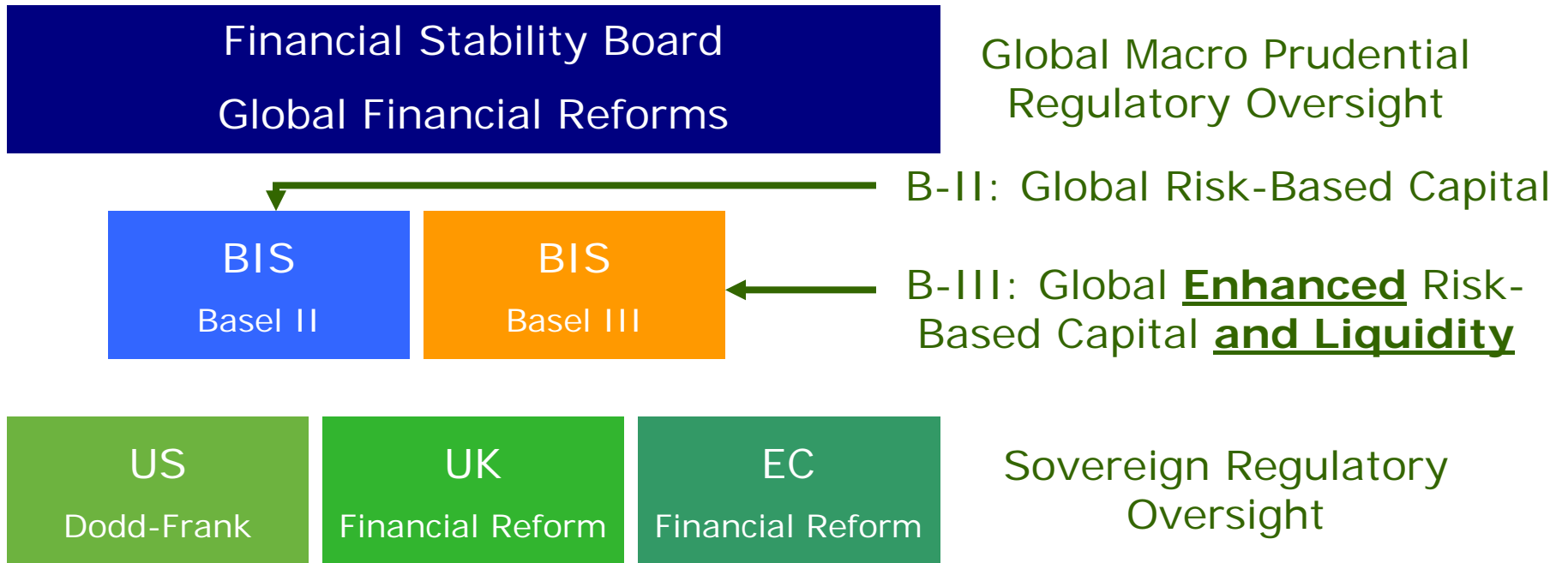
## Entire financial services industry is being reengineered

- Regulations affect all market participants within the financial services industry
  - Banks
  - Investment Funds
  - Rating Agencies
  - Insurers
  - Regulatory Agencies
- Proposed regulatory reforms from various issuing bodies often carry conflicting objectives
  - Risk aversion vs. maintain access to credit
  - Preserve market liquidity vs. curb speculation
  - Generate job/economic growth vs. create counter-cyclicality
- Bank funding has been constrained
  - Sources of funding have been reduced or eliminated during due to recent crisis and ongoing regulatory reform process
  - Has led to heightened market volatility and increased exposure to capital/liquidity shocks
- Financial regulations have direct impact on all non-financial companies
  - As corporations define their future funding strategies, management needs to understand the capital and liquidity requirements being drafted in new financial regulations

# Framework for Global Regulatory Reforms

Reforms are being drafted at all levels globally and simultaneously

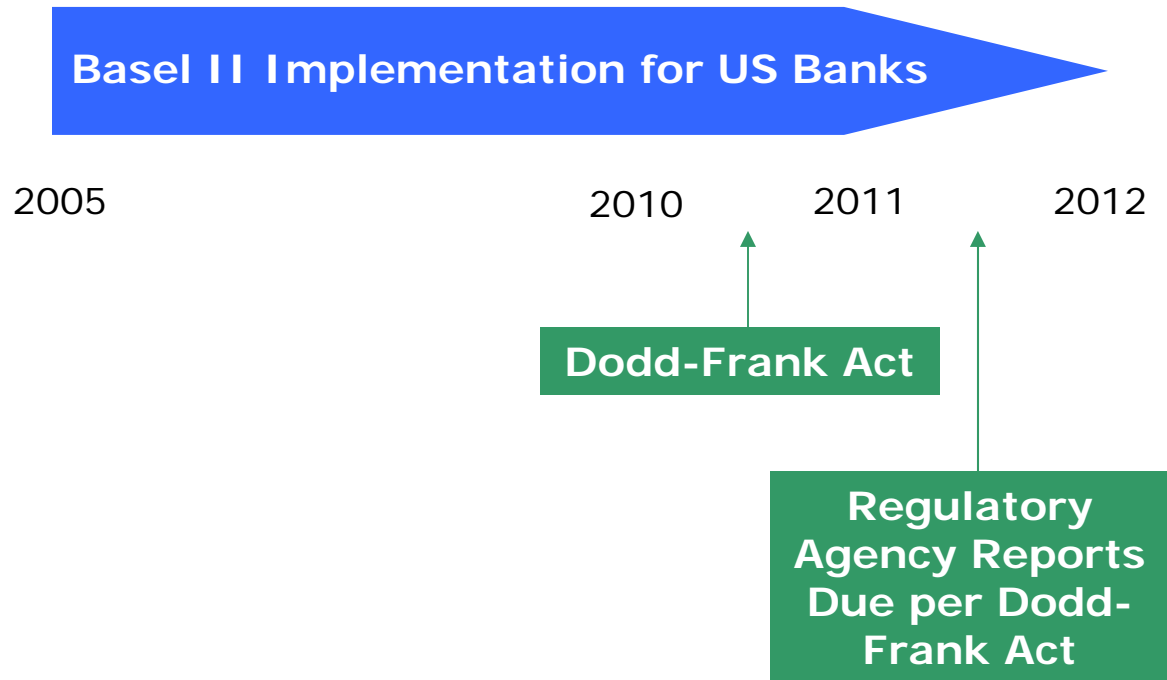
- Creates conflicting regulations
- Reduces visibility for form of final regulations



# Framework for Global Regulatory Reforms

## US regulatory reforms can conflict with Basel II

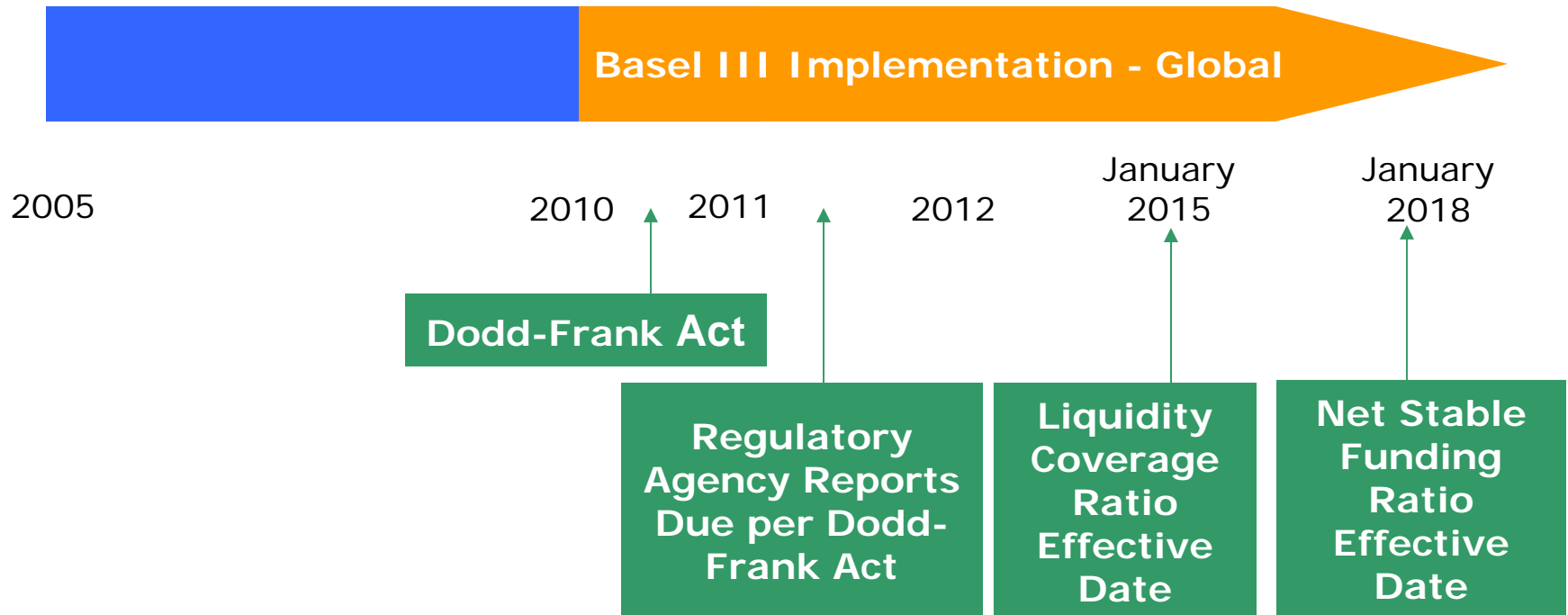
- Certain provisions of the Dodd-Frank Act conflict with Basel II
- Problematic as US banks are in the process of implementing Basel II
- Raises risk of creating competitive disadvantage for US banks versus non-US banks who are already operating under Basel II



# Framework for Global Regulatory Reforms

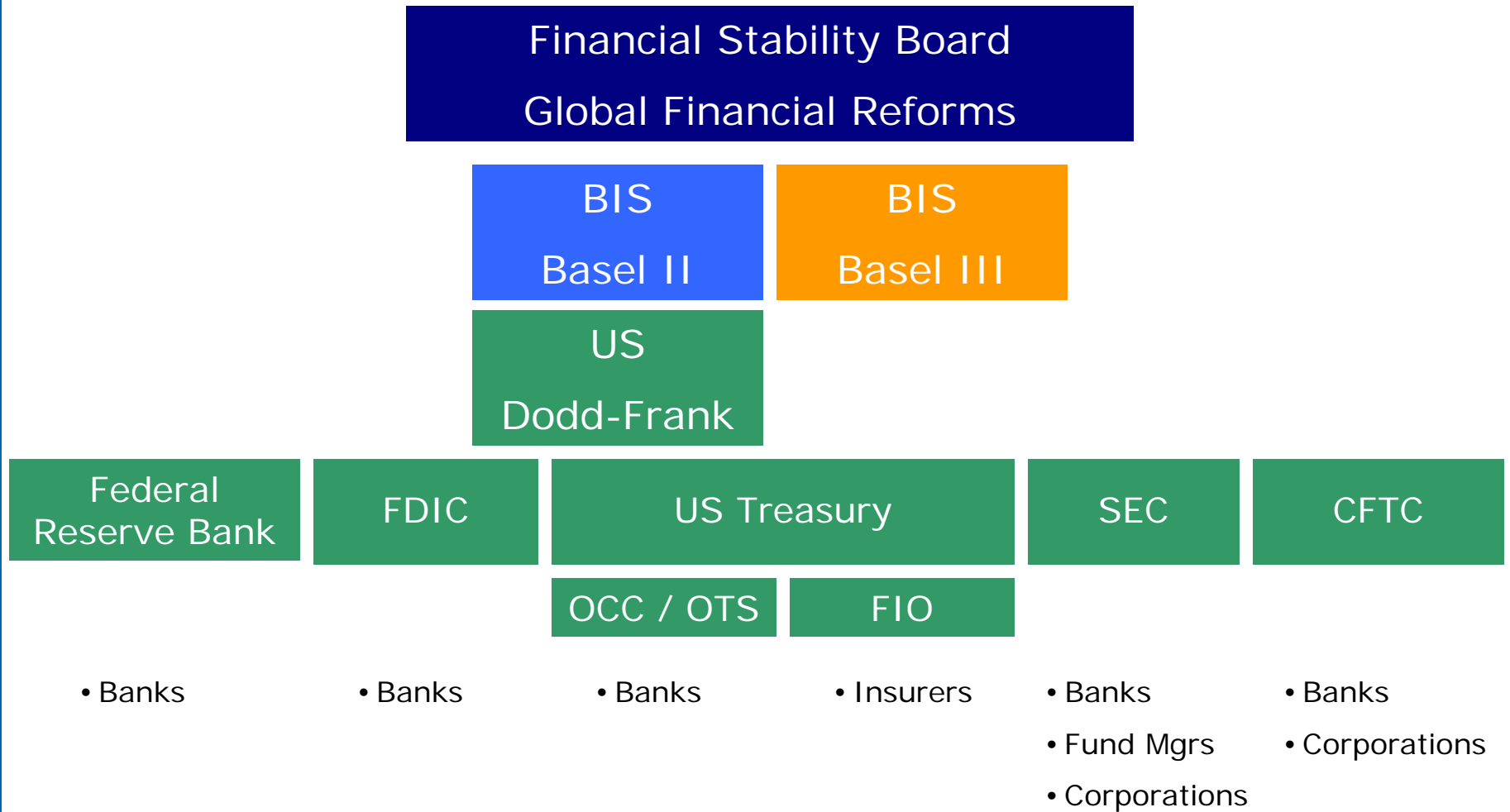
## Basel III creates added uncertainty

- Certain details for capital calculation remain undefined
- Liquidity coverage rule is left open to local sovereign authorities that allows them to require implementation earlier than BIS's 2015 deadline



# US Regulatory Reforms

US institutions face simultaneous global and US regulatory reforms



# Dodd-Frank Act

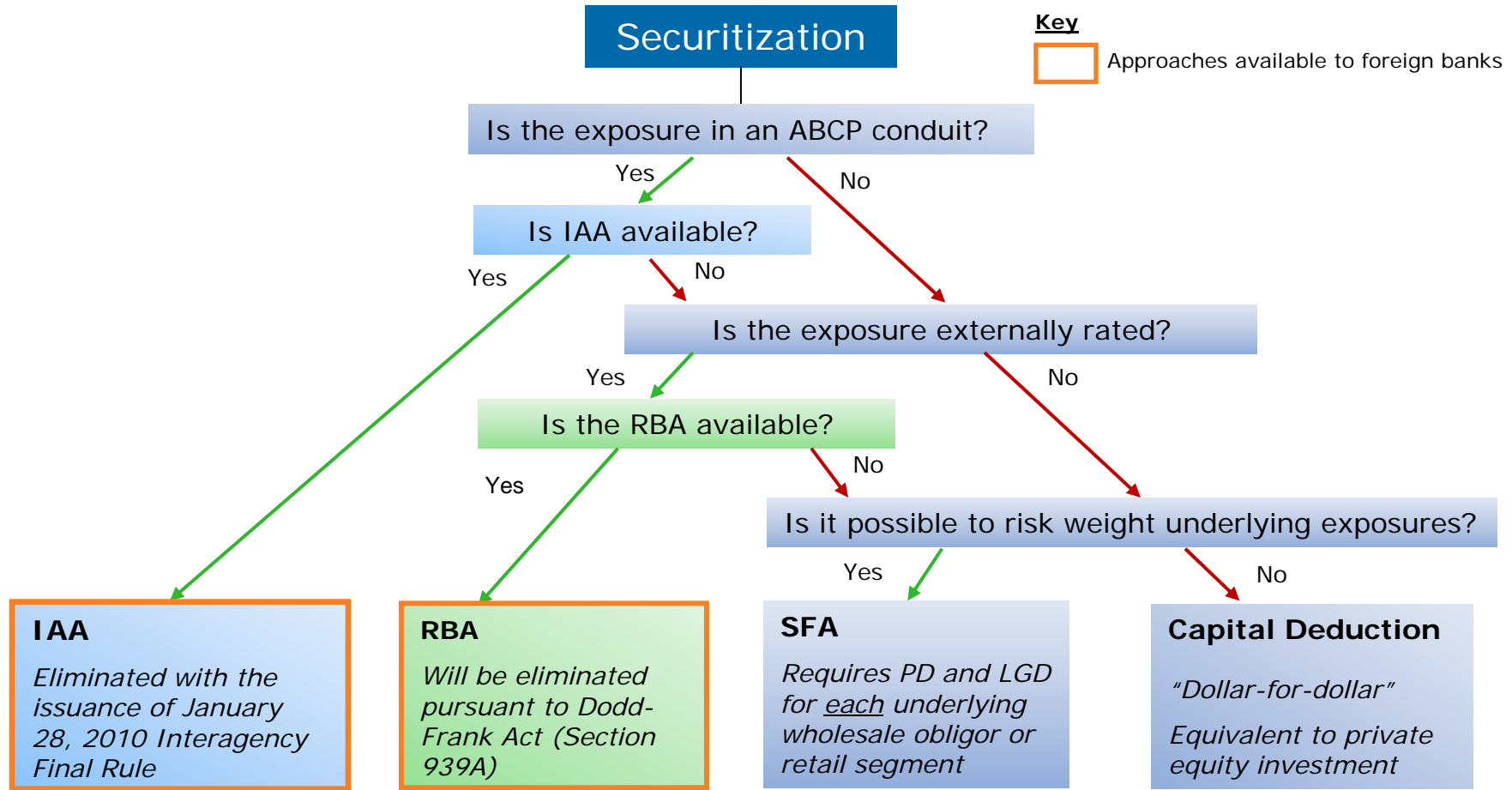
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## Challenges arising from Dodd-Frank 939A: Removal of credit ratings

- Pervasive impact on banks, money managers, and broker-dealers
- Conflicts with Basel II and Basel III (heavily reliant on credit ratings)
- Effectively remapping financial industry's "DNA Code"
- US bank regulators are studying alternatives prior to issuing proposed rule
- Industry is engaged in constructive dialogue with US bank regulators to define viable alternatives to external credit ratings for purposes of bank regulations

# Basel II Securitization Decision Tree

**Is the Exposure Securitization Under Basel II?**  
 Are cash flows based on the performance of underlying assets?  
 Are underlying exposures financial assets?  
 Is there a tranching of credit risk?



# Basel III

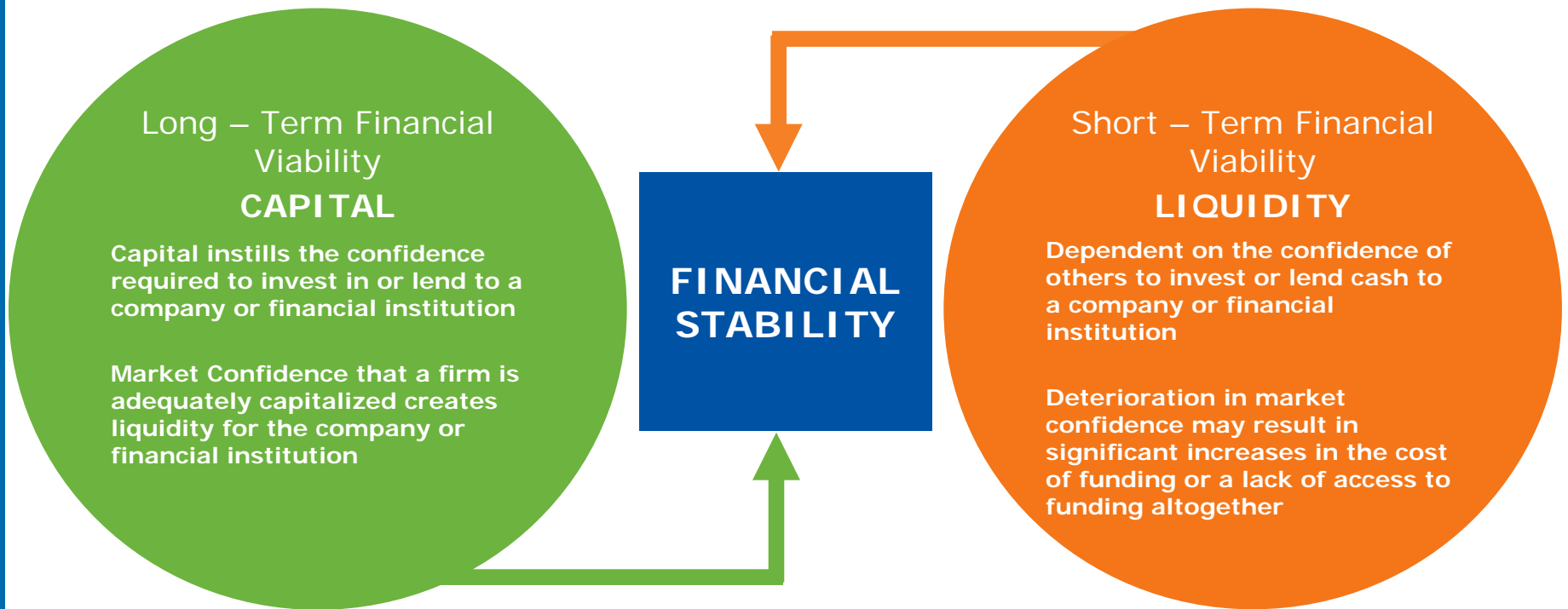
## Example of Challenges arising from Basel III Liquidity Coverage Ratio

- Current draft creates uncertainty for liquidity to financial markets
  - Requires banks to hold liquid assets equal to 100% of unfunded commitment to a financial institution and special purpose vehicles
    - Can constrain liquidity available to any financial institution
    - Can reduce liquidity available to any corporate client's trade receivable securitization
  
- Current draft creates uncertainty for corporate liquidity
  - Requires banks to hold liquid assets equal to 100% on unfunded commitments under liquidity facilities to non-financial corporations
    - Can constrain liquidity available to a corporation's CP backstop line of credit
  
- US and international regulators are beginning to study LCR in preparation for drafting regulations
  - Industry is engaged in constructive dialogue with regulators

# Role of Capital and Liquidity

## Bank capital creates the market confidence needed to support liquidity

- Banks need both robust capital and liquidity



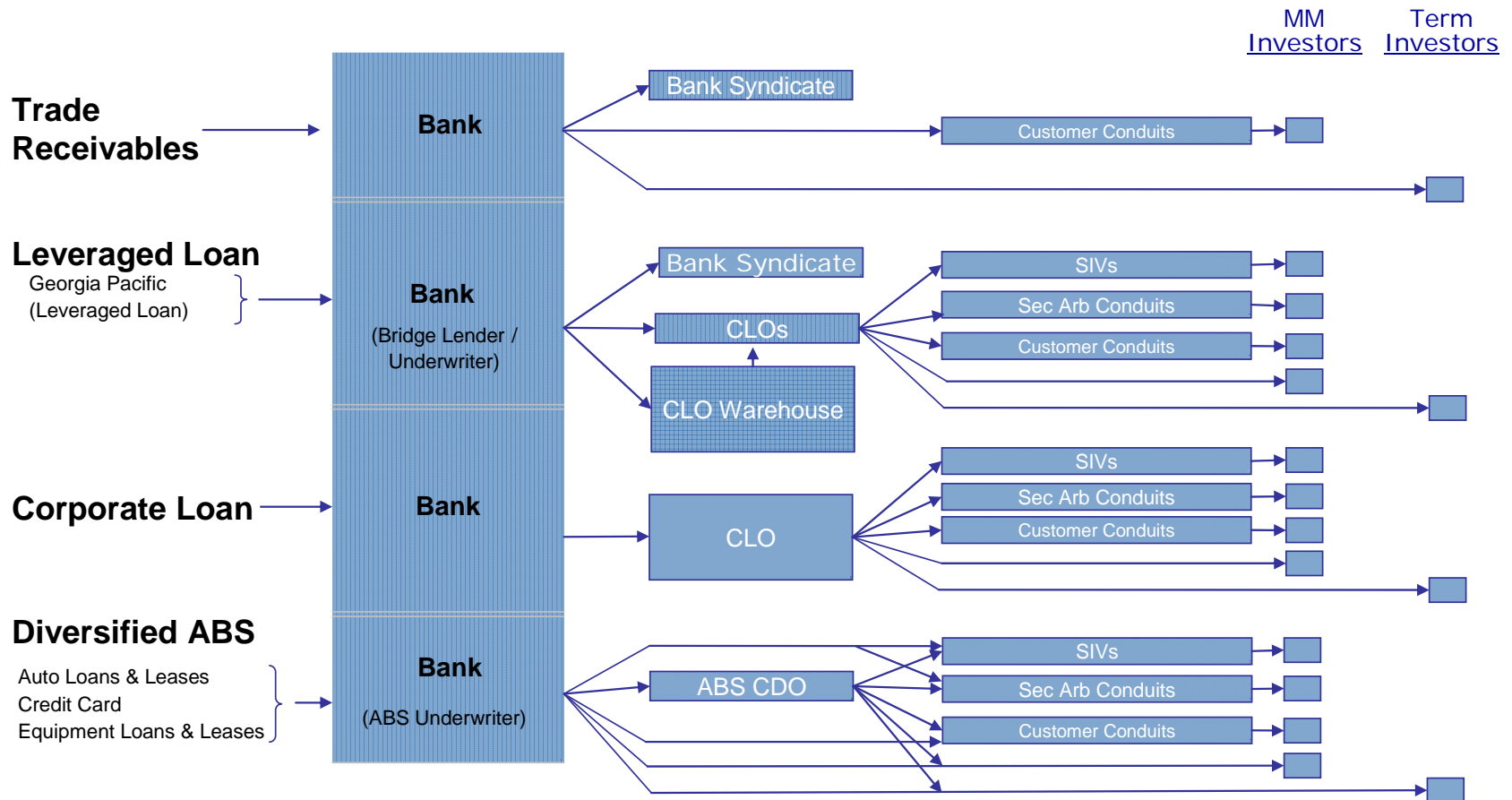
# Channels of Liquidity Summary

## Financial disintermediation over 30 years created inter-connected channels of liquidity

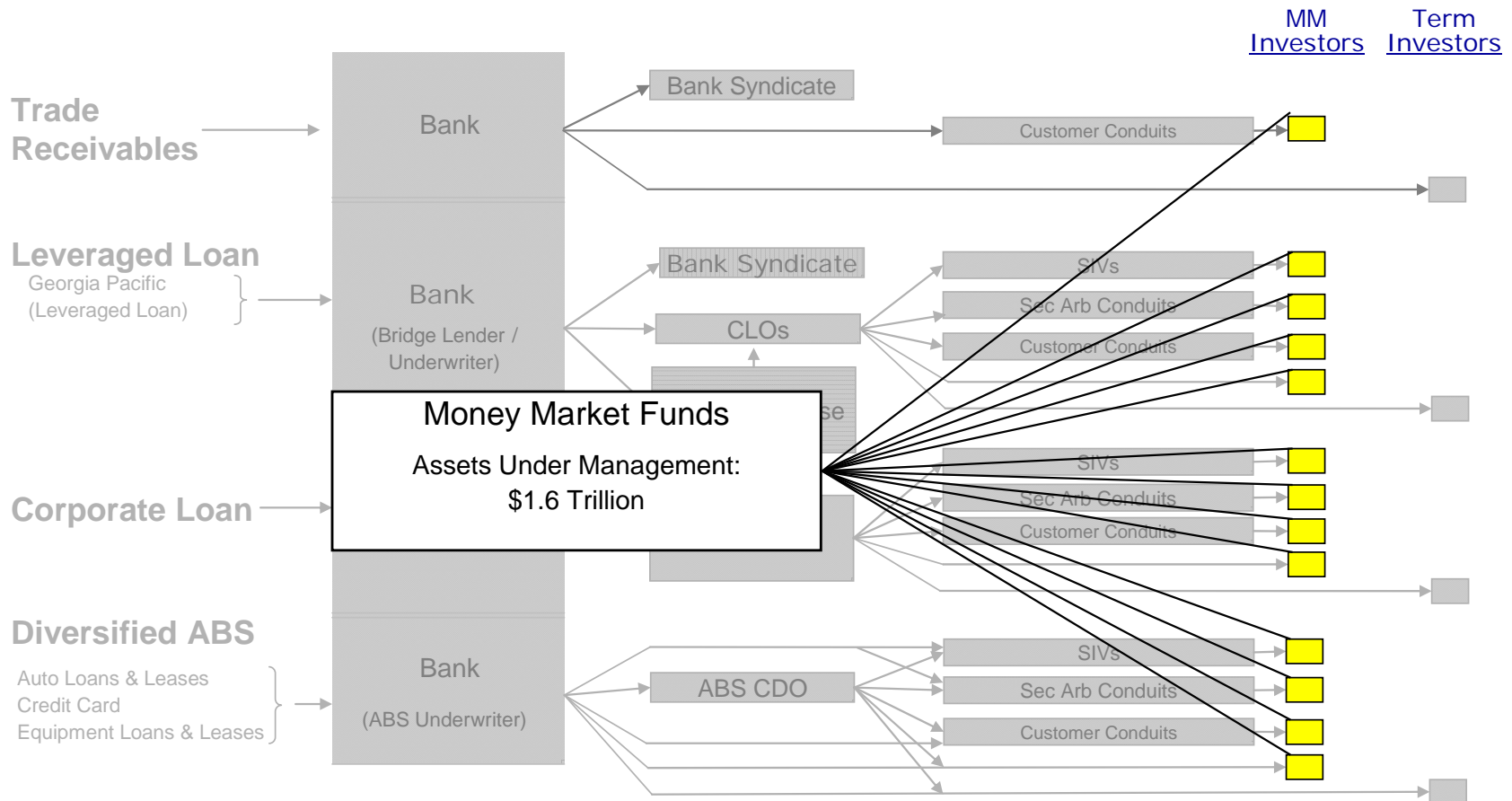
- Market contraction over past three years due to the collapse of large channels of liquidity
- Current market's slow re-establishment of liquidity flows is due to:

- 1 Financial re-intermediation**
  - Fewer remaining channels of liquidity
  - More concentrated channels and ultimate owners of risk
- 2 Chilling effect caused by uncertainty surrounding various regulatory reform proposals**

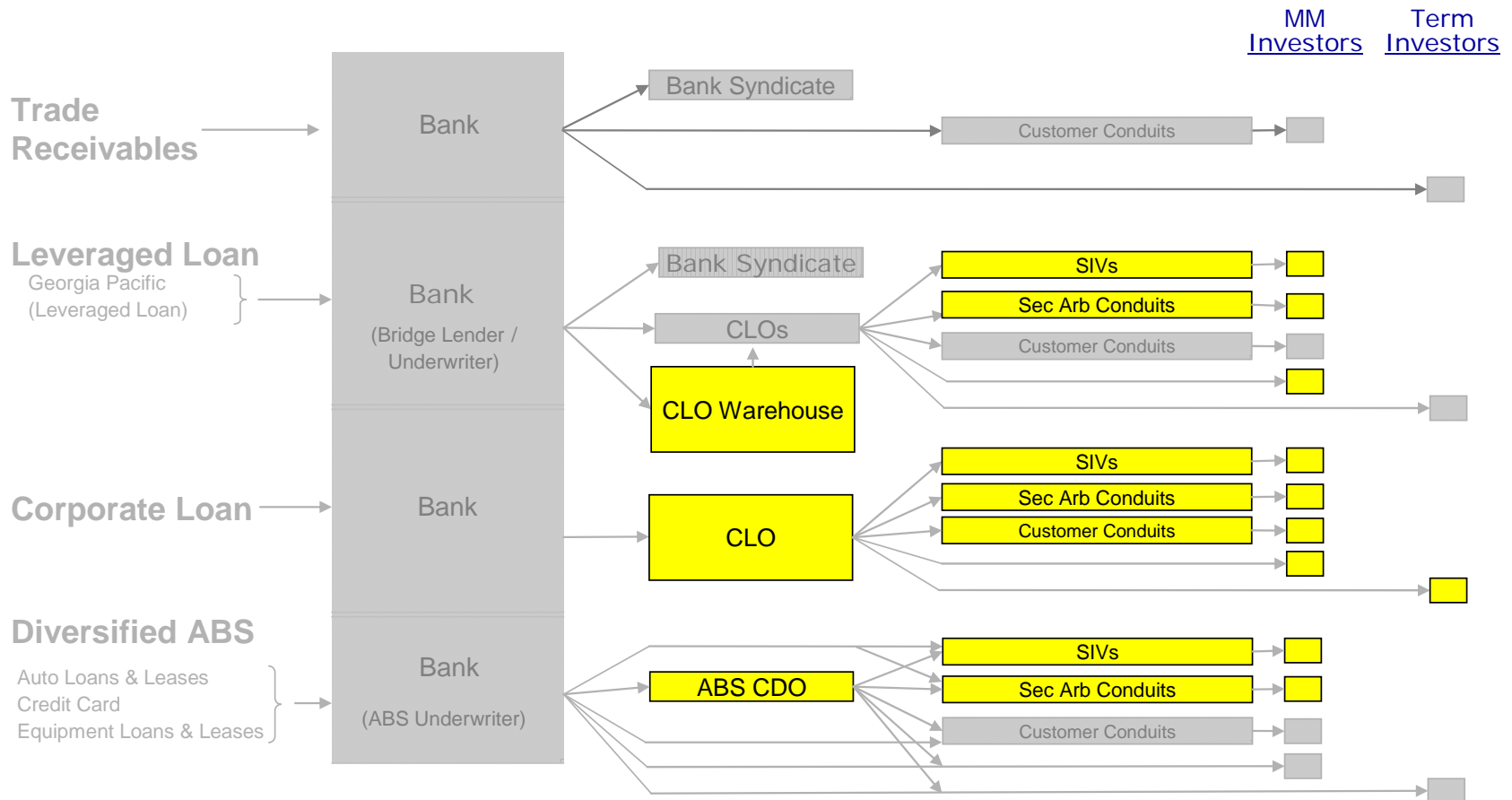
# Pre-Crisis Channels of Liquidity



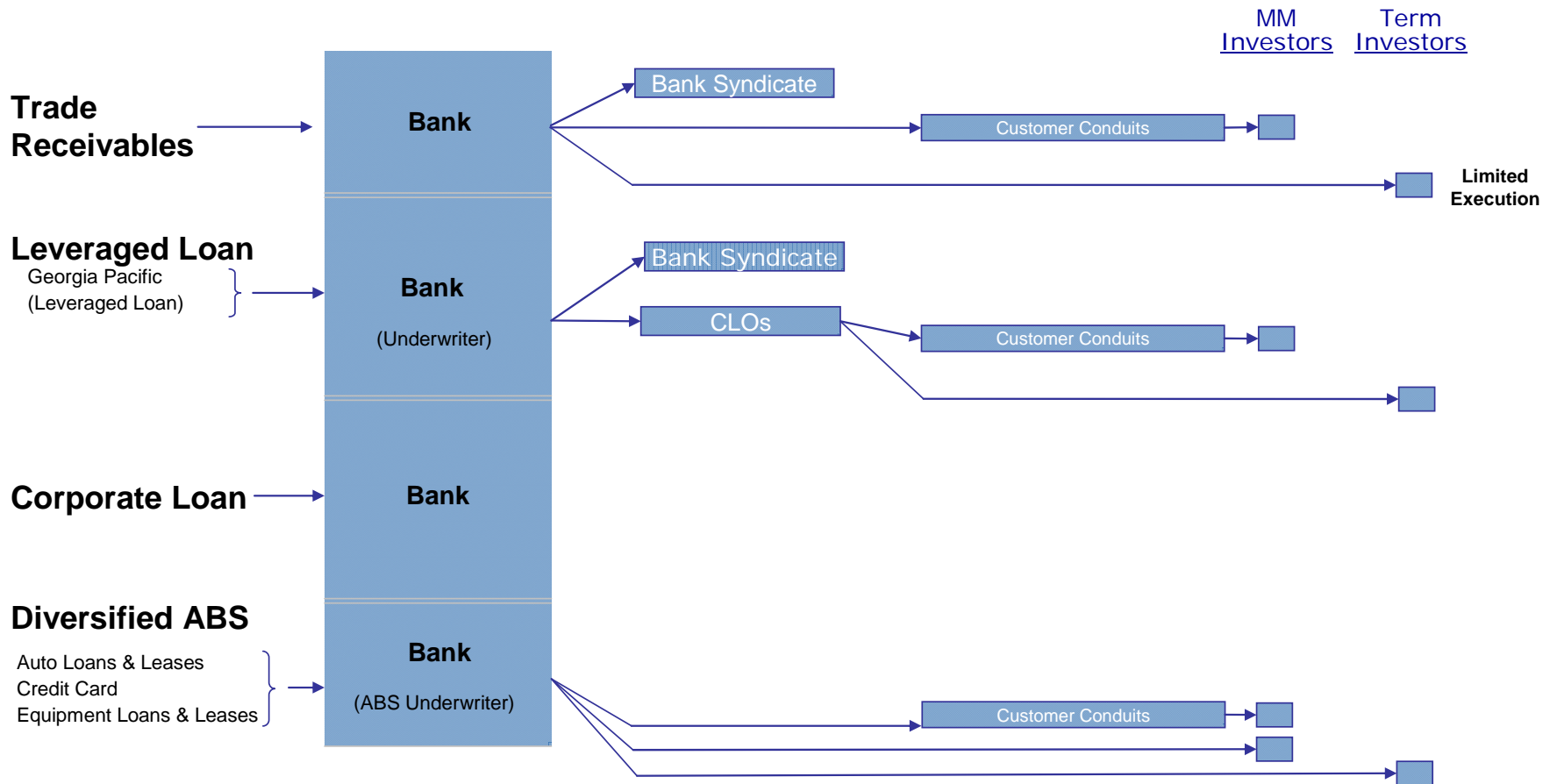
# Pre-Crisis Channels of Liquidity



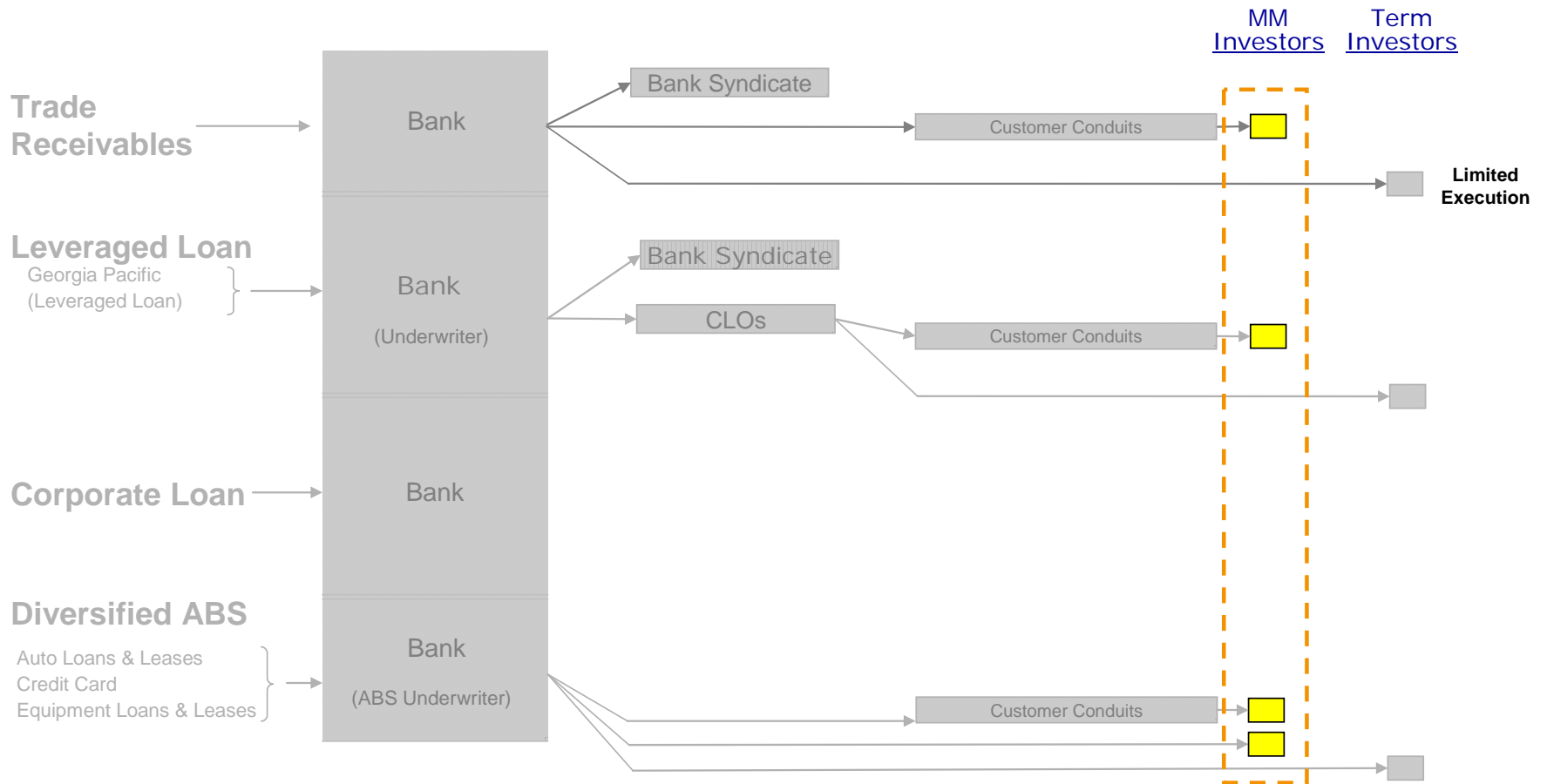
# Certain Channels Vanished



# Post-Crisis Channels of Liquidity



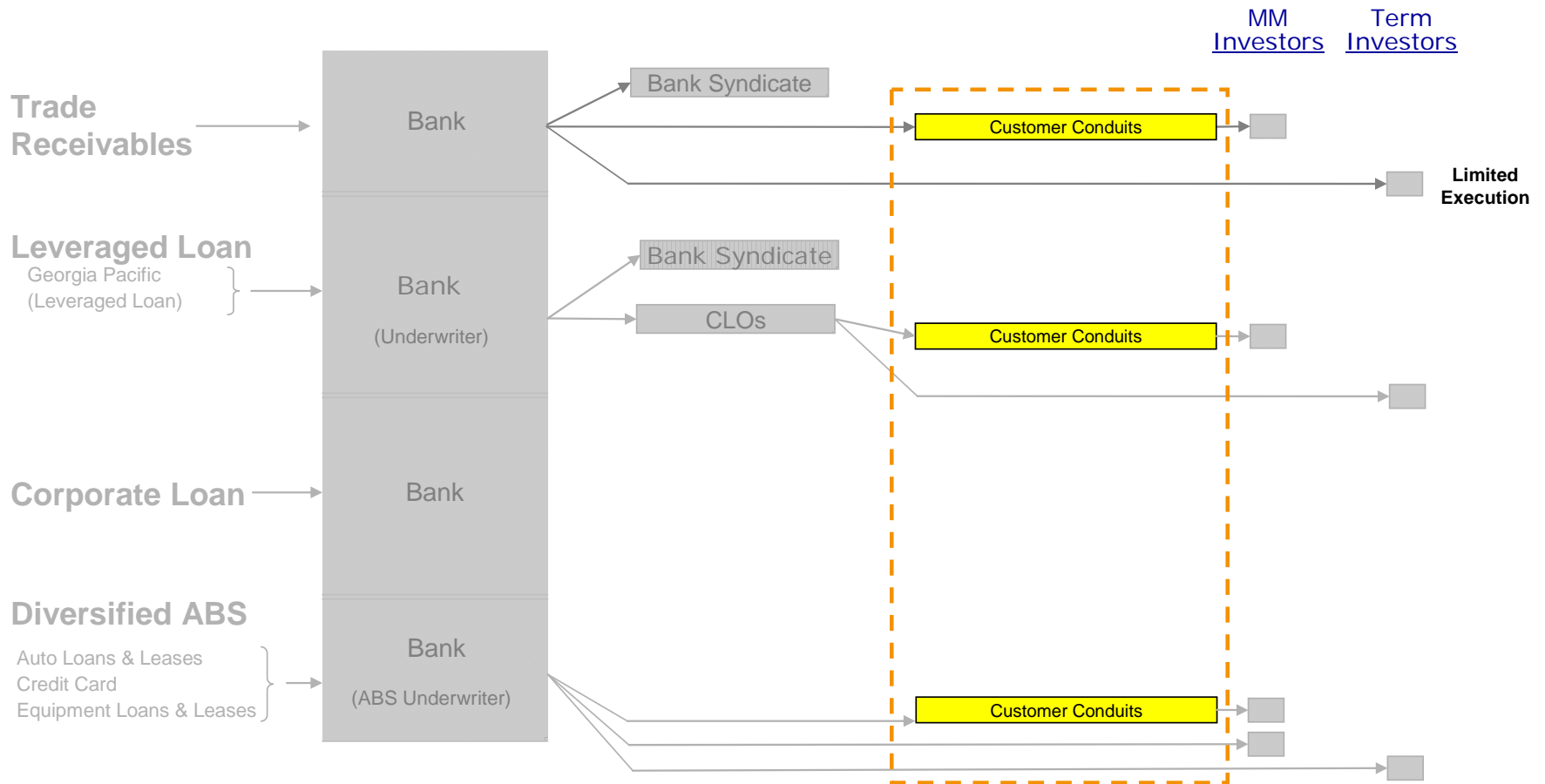
# Impact of Reforms on Liquidity Channels



**Reforms affecting money market funds:**

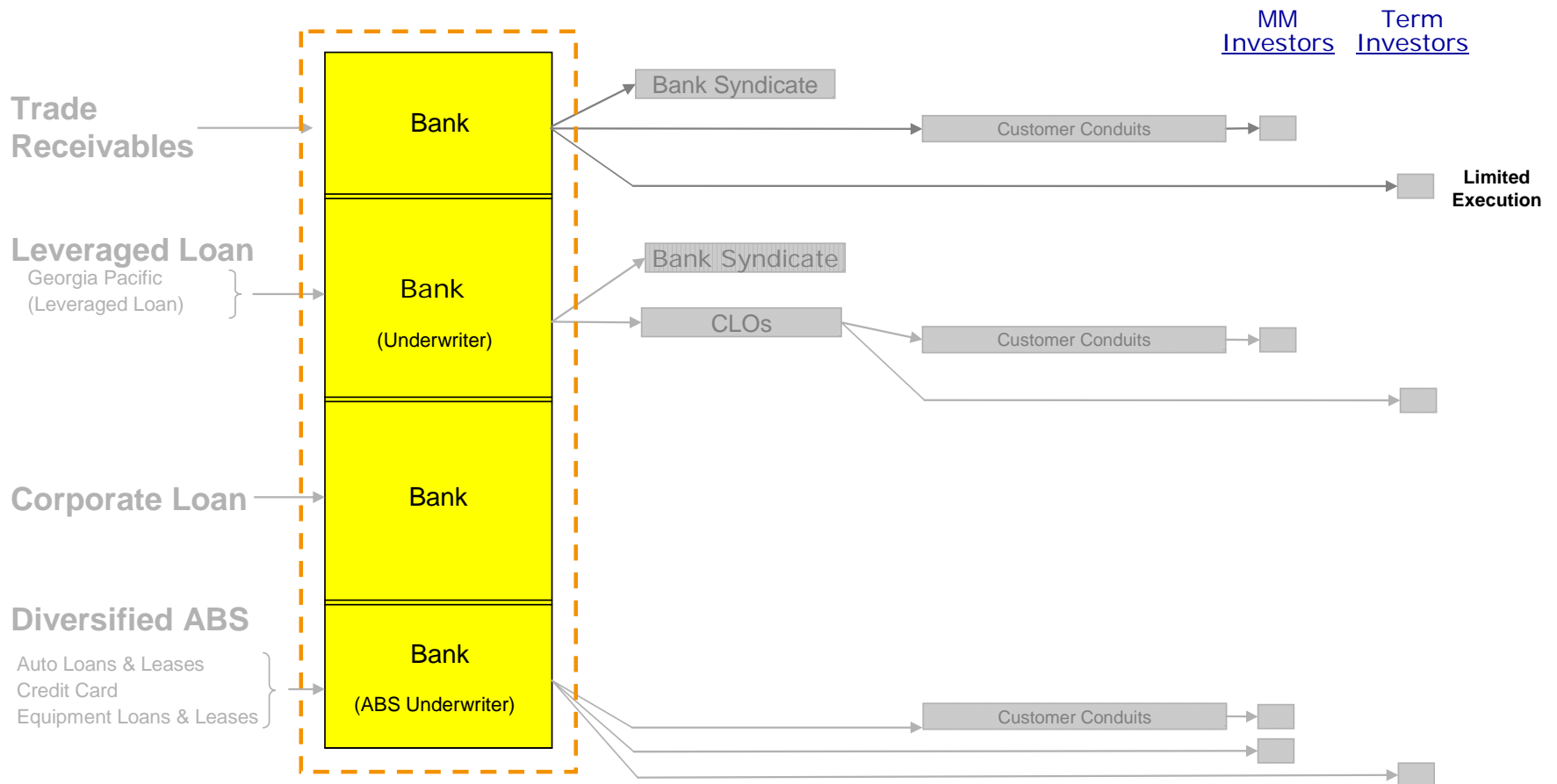
- Money Market Mutual Fund Reform
- Dodd-Frank Act

# Impact of Reforms on Liquidity Channels



- Reforms affecting Customer Conduits:**
- GAAP accounting consolidation
  - Bank securitization safe harbor
  - US bank regulatory capital
  - Dodd-Frank Act
  - Basel II and III
  - Reg AB II

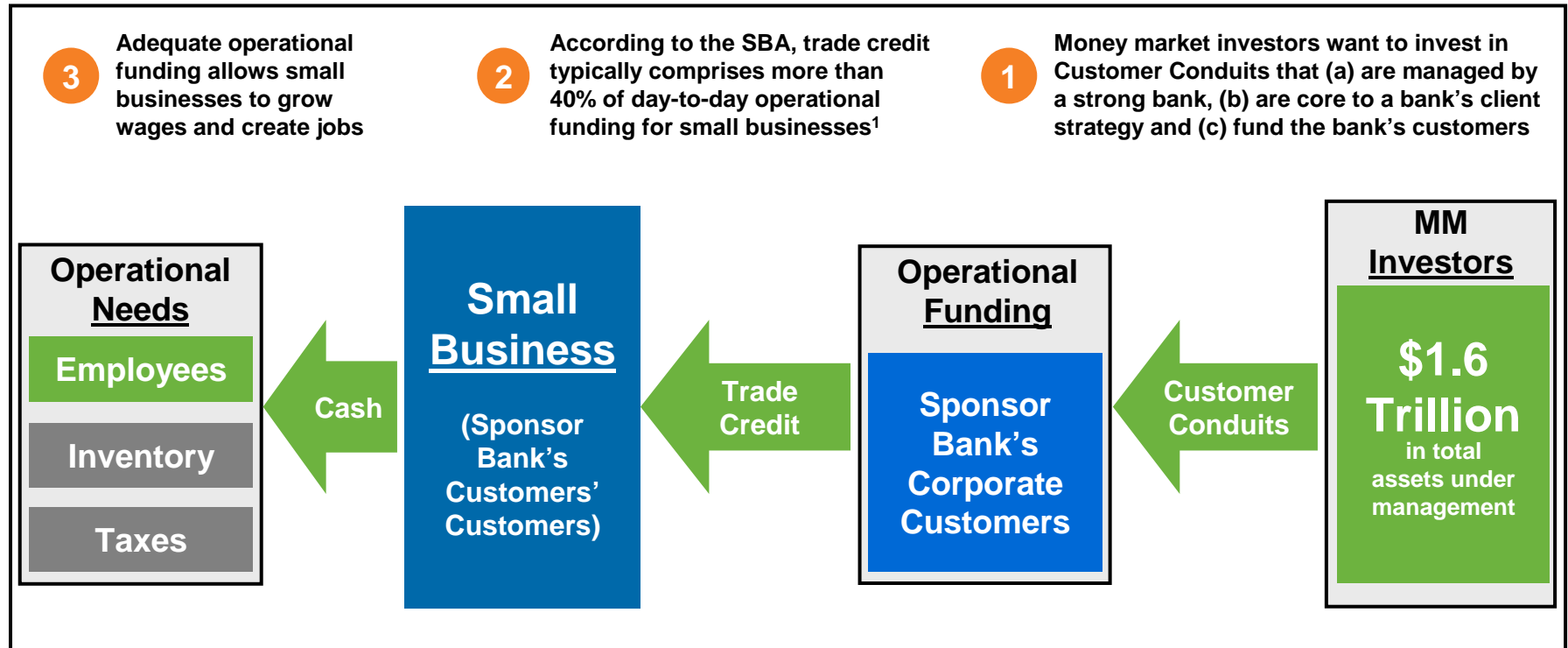
# Impact of Reforms on Liquidity Channels



Reforms affecting banks:		
Direct		Indirect
■ GAAP accounting consolidation	■ Basel II and III: regulatory capital and liquidity	■ Money Market Mutual Fund Reform
■ Bank securitization safe harbor	■ Dodd-Frank Act	
■ US bank regulatory capital	■ Reg AB II	

# Funding Ecosystem

Customer Conduits facilitate job creation by connecting small businesses to investors seeking to invest the \$1.6 trillion of cash held in money market funds



<sup>1</sup> U.S. Small Business Administration: Understanding and Controlling Cash Flow (May 2009), operational funding defined as short-term debt

# Impact of Reforms on Corporate America

## Financial reforms have an impact on corporate liquidity

- As companies define their future funding strategies, they need to be aware of the uncertainty surrounding capital and liquidity measures required by Basel III and Dodd-Frank
  - Specifics are unknown at this time, but like an iceberg – only a small portion is visible. Ability to navigate through the various regulations will be critical
  - Assume financial institutions will be required to hold more capital and liquidity and that capital and liquidity will be more expensive
  - Implementation mandated for future, but plans are being put in place today
  
- Corporate management should seek insight and advice from their lead bank relationships regarding new liquidity and capital rules
  - Analyze how it may affect banks
  - Develop view on outlook for banks capacity to provide liquidity to markets and/or clients
  
- Engage in discussion between regulators and US financial institutions
  - Explain potential impact on US economy