NEGATIVE TERRITORY

Are corporates on the verge of having to pay banks interest for the privilege of holding their money? Peter Bartram investigates

Five of Britain's corporate treasurers may have felt they had entered a topsy-turvy world of finance last December. As the old year closed and 2014 beckoned, they discovered that their bank was reluctant to take year-end cash deposits.

In two cases, the treasurers ended up paying negative interest on the money being parked at the bank. And these were not smaller outfits that would be easy game for bank profit skimming.

"These were companies that are large and would be expected to have good relationships with their banks," relates Martin O'Donovan, deputy policy and technical director at the ACT, who uncovered the issue as part of a poll of 28 corporate treasurers.

O'Donovan notes that it isn't unusual to find "strained conditions" in sterling money markets over year and quarter ends. But the bigger question is whether these conditions could become more entrenched and whether negative interest rates could become a more familiar feature among other currencies.

Most notably, as spring moved towards summer, there was continuing speculation as to whether the policy rate of the euro would go negative – and, if so, what the fallout would be. In any event, corporate treasurers are approaching this new debate after several years in which low interest rates have focused more attention on how to manage cash balances to best effect.

"I think the subject of negative interest rates has been on corporate treasurers' minds for the past couple of years," says Chris Huddleston, who runs the corporate and institutional treasury money market desk at Investec, a specialist bank and asset manager. "Everyone is very aware of the situation."

Barren earth

The backdrop to the debate about negative interest rates is the frantic desire of governments to stimulate their economies before they have to face their electors. That need has become somewhat less urgent in Britain as the first green shoots of recovery have sprouted.

But in the eurozone, the earth is still barren. There is talk of negative interest rates being one option to get corporates to spend some of their cash mountains as a way of stimulating stagnant economies. The notion has a respectable antecedent.

No less an economics luminary than John Maynard Keynes gave an approving nod towards a carrying tax on money in his 1936 opus, *The General Theory of Employment, Interest and Money*, probably the single most important book on economics published in the last 100 years. Eventually, however, Keynes rejected the idea because he couldn't think of a practical way to do it.

That hasn't stopped others coming up with wacky suggestions ranging from magnetic stripes on paper money that would act like a kind of Oyster card, deducting value based on how long it had been held, through to a regular lottery that would declare invalid all banknotes ending in a particular single digit.

But given that most money these days is held as electronic signals in bank accounts, none of these inventive ideas tackles the issue of getting corporates (and individuals) to spend their money and, thus, stimulate the economy. So can negative interest rates do any better?

Unfortunately, it seems unlikely that they can, even in Europe. "They would do very little and have more of a symbolic impact," argues Ken Dickson, investment director at Standard Life Investments. As economists point out, the stimulus for corporates to spend is confidence that the investment will produce a

IMPACT OF REGULATION

It's worth mentioning that the current debate does not focus on 'real' negative interest rates – where the rate of interest is positive, but below the level of inflation. Many countries, including Britain and the United States, can point to lengthy periods of negative real rates in their economic history.

The current debate focuses on 'nominal' negative rates, where there is actually a minus sign in front of the number. There is plenty of evidence that the seeming increase in nominal negative rates at quarter and year ends is due to a range of technical factors.

Principal among these are the new liquidity and leverage ratios in Basel III. Take the liquidity test first. It focuses on whether the bank can withstand a 30-day closure of the markets and still have cash. So if the bank takes a deposit for less than 30 days, the presumption is that it will mature within that period and not be renewed. Result: the deposit does nothing to aid the bank's liquidity ratio.

But, worse, that short-term deposit may actually harm its leverage ratio, which is set at a minimum of 3% by Basel III. The leverage ratio is calculated by dividing the bank's 'tier 1' capital – essentially shares and retained earnings – by its average total consolidated assets. So if a bank suddenly finds hundreds of millions, even billions, being dumped on it near a quarter end – when the calculations are made – it may find itself in danger of breaching the 3% limit, unless it can find a home for the money and convert it from a liability into an asset.

Even though Basel III regulations are still being phased in, banks feel they need to show they will be able to hit the liquidity and leverage ratios demanded in time. "It's a catch-22 situation," says the ACT's Martin O'Donovan. "Because they have to show they can reach the target, they have to get there sooner."

Furthermore, banks are also facing some tax pain. First, there is the UK bank levy, which is calculated on the size of the balance sheet at the year end. So if a bank grosses up its liabilities – such as extra customer cash – over a calculation date, it ratchets up its levy payment.

Secondly, there is the threat of a financial transaction tax, as proposed by the EU. Explains O'Donovan: "If this is charged per transaction, and depending on which transactions are caught, then very short-term transactions become very unattractive – another reason why banks will not want short-term deposits."

sought-for return. But the depressed logic of a downturn is that there are fewer good-quality assets to invest in.

Investment policies

Yet the prospect of sitting on a large pile of cash that banks don't want to hold could become more worrying for corporate treasurers in the months and years ahead. The financial impact of holding money at a bank that pays 0% interest and one that 'pays' minus 0.25% may not be huge – but the psychological impact is greater.

That is because most companies have investment policies that focus on protecting the value of the capital. Actually placing money in an account with a negative rate that erodes capital may require a change to the investment mandate.

"If negative rates came, my view is that corporate treasurers would have to look at their investment guidelines and the credit ratings of what they could invest in," says Adam Hayter, head of international liquidity and investment management at RBS.

If corporate treasurers found themselves being charged negative rates for holding euros, Hayter suggests there are two strategies they could explore. "First, they'd need to make sure that their investment strategy does not go out too far on the yield horizon," he says.

"Second, as we are seeing very low swap rates to dollars at the moment, there would be the potential for them to swap their excess euros into dollars or another currency where the rates are a little better."

And it seems that corporate treasurers are already starting to move towards those yield horizons. "A third of the business we do today with corporates is in products that they would consider slightly riskier than a conventional fixed-rate deposit," says Huddleston. "There are products where we can embed a derivative to provide a degree of upside."

One possibility for the treasurer faced with a bank wielding negative rates is to put more cash with a money market fund (MMF). But MMFs have to find a way to invest their deposits, usually in AAA-rated paper, so their yield is likely to be a reflection of the underlying instruments the fund has purchased. In a lengthy period of negative bank interest rates, those returns are unlikely to show much margin above those available from a bank.

So if there are few high-return investments available and MMFs have only limited appeal, the final option for treasurers may be to hand cash back to shareholders. Indeed, it could well be that shareholder clamour for special dividends or share buybacks may rise if the returns on cash piles remain low or become worse.

"You have this interesting paradox – shareholders looking at a corporate entity that has some cash on the balance sheet may be able to find more profitable ways to invest that cash than the corporate itself," says Stanislav Varkalov, director of accounting and regulatory advisory at Lloyds Bank.

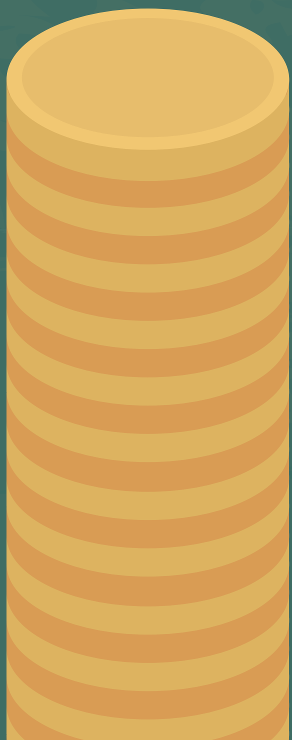
In reality, most companies are likely to treat any negative interest charges in the same manner as an administration or custody fee

"If I'm a shareholder, I may want to put pressure on the corporate to give me the money back because if it can't invest the money in the expansion of its key business – and it has less incentive to keep the cash on deposit with the bank because that may produce lower returns – then I may be able to invest in asset classes that deliver a better return."

So, perhaps, treasurers sitting on cash should expect some increasingly pointed questions at annual general meetings.

And should negative interest rates become a semi-permanent feature of the landscape, companies will need to resolve how to treat them from an accounting perspective – are they an expense or negative income? In reality, most companies are likely to treat any negative interest charges in the same manner as an administration or custody fee.

Even so, depending on how the IT system that handles interest accruals is set up, it may need to be adjusted to deal with negative rates. Changing that should prove little more than an irritation.



Bottom-line question

But the bottom-line question is whether negative interest rates will become any more than a short-term trouble at quarter ends. A long-term period of nominal negative rates in a jurisdiction as large as the eurozone would be an experiment without precedent.

Don't rely on the experience of negative rates for short periods in Sweden and Denmark in recent years as a guide to what would happen. In these Baltic states, there was very little impact on money markets or the real economy. But, then, these are comparatively small economies and they were special cases.

Long-term negative in euroland – or, less likely, in Britain – would be a different ball game because of the scale. "I think negative interest rates are very much a last resort because the effects of them are very unpredictable," says Rob Wood, UK economist at Berenberg Bank and columnist for *The Treasurer*. "You only go down this route if you are really, really desperate and don't have an alternative policy you can turn to."

So corporate treasurers better hope that Mario Draghi, president of the European Central Bank, has a workable alternative in mind.

Peter Bartram is a freelance journalist, editor and author