Work those cash reserves

KIEREN WRIGHT ANALYSES THE BEST WAY FOR TREASURERS TO SECURE THE BEST DEAL ON BANK DEPOSITS.

THE EMPHASIS ON DUE DILIGENCE IS A WELCOME DEVELOPMENT IN UNDERSTANDING AND REDUCING RISK IN THE SYSTEM.

"The shape of the interest rate or yield curve is such that the best value from deposits can be obtained at longer maturities. But we all know that to be able to make that commitment treasurers need to be confident about their cashflow. As well as deciding on maturity, working out the desired level of deposits in the first place is a challenge given competing demands in the business and the low level of nominal interest rates and real interest rates that are actually negative.

Knowing the nature and terms of the deposit forms only part of the decision-making process. In the past few years there has been increased "credit tiering" in the market whereby corporates and financial institutions have become more discerning about the counterparties they deposit with.

Security is one of the main drivers in an uncertain world. There are various ways of judging the security of a bank and it is striking how different firms have a range of metrics they look at.

In addition to their own views, firms often seek out the views from the wider market – from fixed income markets, for example, the credit default swap spread (which measures the cost of insuring a bank's debt), to equity markets and how resilient a bank's share price is, through to the often used rating agencies' reports on banks' creditworthiness.

Other metrics might include what business banks are involved in – high risk or low? Does a bank have a decent capital ratio to withstand shocks? Is it a branch of a larger bank or is the UK ring-fenced from other global operations?

The emphasis on due diligence is a welcome development in understanding and reducing risk in the system. Sometimes the highest deposit rate in the market may reflect lower creditworthiness. It might be helpful to think of a deposit rate as the risk-free rate that can be achieved on government debt or gilts (the rate that banks need to pay to compete with the government) plus a credit risk premium. Of course, sometimes strong banks pay attractive rates because of a desire to build a relationship with the firm. Again this comes down to individual judgments about a bank's underlying strength and what the rate represents – a higher risk premium or the bank's desire to win your business.

The changing banking regulatory regime with its focus on capital and liquidity will continue to affect deposit rates. The moves by the Financial Services Authority to encourage banks to hold more high-quality liquid assets (to protect against the risk that a bank may not roll over its deposits) are another compelling inducement for banks to pay more for long-term deposits than short-term.

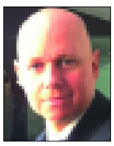
Once a client has been through the normal due diligence, it is then important to find the right product. Again, the right mix of relationship manager and deposit specialist should help. Competition in the corporate deposit market has warmed up significantly in the past few years, with new entrants such as Santander looking to build relationships and support corporates and institutions. This has led to an ever wider choice for depositors, from plain vanilla fixed term and notice accounts to complicated structures that require multiple derivatives as part of the package.

The details will depend on what the corporate is looking for – fixed or floating, long term or short term. While much has changed over the last few years one element has remained the same: bankers need to work with their corporate and financial institution clients to understand what they require when they put money on deposit.

The economist John Maynard Keynes often said there were three types of demand for money: precautionary – money being held for a rainy day; speculative – funds earmarked for investment; and transactional – the money needed for day-to-day working capital purposes. The first two can often lead to longer-term deposits while the third is generally short-term.

Banks want deposits to help them grow their business, so despite the low-interest rate environment any treasurer with longer-term deposits should work with their banks to secure good terms.

Clearly in coming years treasurers will continue to want to work with banks that deliver a good relationship across product lines; deposits will always be a key one."



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