Finding return in a sub-zero world

NEGATIVE INTEREST RATES MAY START TO BECOME A WIDESPREAD ISSUE FOR CORPORATE DEPOSITORS. SUZANNE JANSE VAN RENSBURG EXPLAINS THE IMPLICATIONS FOR TREASURERS

Five years on from the peak of the financial crisis, we have to accept that ongoing volatility is now the new normal. Governments and central banks continue to implement monetary-easing policies in an effort to break the existing cycle, while corporate treasurers work with prolonged periods of low interest rates on deposits. Some treasurers already face negative deposit rates and there is a prospect of this becoming widespread.

Negative rates

A little history

The abstract concept of short-term and overnight negative interest rates flies in the face of the conventional wisdom that interest rates earned on balances are always above zero, which is evidenced by many banks' system constraints in handling negative interest rates. This is principally because investors can hold cash in multiple currencies, although for a number of reasons this still does not provide a logical floor for market interest rates.

In the not-too-distant past, Denmark, Japan, Sweden and Switzerland have all dabbled with short-term negative interest rates, as have some individual institutions. Swiss clearing banks imposed negative interest on balances placed with them last year in order to discourage incoming Swiss franc deposits. In July 2012, Denmark set its 14-day certificate of deposit rate to negative in an effort to prevent currency inflows from the eurozone in search of a safe haven. This has proven successful, as rates, while still negative, have improved. During the 2008 financial crisis, a major US bank imposed a negative interest rate – a penalty – on deposits over $50m.

Central banks in Denmark and Sweden have also, at various times, set their commercial bank deposit rates to below zero, which attracted attention, but had little practical impact because the deposit amounts involved were relatively small.

Meanwhile, bond investors in the eurozone have had first-hand experience of negative yields. At various points during the eurozone crisis, government bonds issued by Austria, Denmark, Finland, Germany, the Netherlands and Switzerland were sold at negative yields. The main driver for investors' willingness to accept sub-zero returns was an overwhelming appetite for perceived security and a need for hedging against the possible break-up of the eurozone.

More recent events

Lately, we have seen the European Central Bank (ECB) and the Bank of England (BoE) consider charging negative interest. In the case of the BoE, where there has been a recent change in governor, the latest reports from its monetary policy committee indicate that there will be no variation to the BoE central bank rate for at least two years. But there has been no further mention of a negative deposit rate, similar to that which the ECB is 'technically prepared' to introduce.

The current zero interest environment in Europe still has not stimulated bank lending in an economy that is flat, and where inflation has fallen sharply. The floor for eurozone money market rates could indirectly bring down other interest rates and government bond yields, and easier credit conditions might encourage commercial borrowing. Ultimately, if perceived low-risk assets become sufficiently unattractive, some stronger banks may again start lending to

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their weaker eurozone counterparts, which are currently dependent on cheap lending from the ECB. Another possibility is that making these low-risk assets unattractive could have a knock-on devaluation effect on the euro, which could, in turn, potentially help exporters by making their international pricing more competitive.

Other possible implications of a deposit rate cut include the draining of liquidity from the eurozone banking system, and the acceleration of early long-term refinancing operation repayments. Negative interest rates on deposits encourage banks to offload their excess deposits, rather than allow their profitability to be eroded and entice banks to lend to each other. The banks in the eurozone would collectively need to reduce their reliance on the ECB. For instance, if a commercial bank makes a loan or buys a bond to avoid negative deposit rates, then it is effectively passing on its reserves to another bank and, ultimately, the ECB.

It is interesting to note the differing motivations here. In the case of the BoE and ECB, the desire was to encourage spending and hence economic confidence/revival. In the case of Denmark and Switzerland, the intent was to guard against an influx of currency.

Important implications

Bank impact

There remains a strong desire to stimulate commercial, industrial and retail lending. Nevertheless, if the ECB and/or BoE proceed to set deposit rates to negative, the implications for banks and, ultimately, their clients as well, are considerable. While regulation has been, and remains aimed at and broadly limited to interbank lending, negative deposit rates could bring consequences for the profitability, balance sheets and capital allocation of banks – with the associated risk that banks might increase their lending rates to compensate.

While one could argue the exact sequence of cause and effect, the end result will almost certainly be the same. These increases in lending rates could have the effect of reducing loan demand, which in turn could reduce the banks' need to attract deposits. In fact, as they could be charged to hold them — either directly through the tax on excess reserves, or indirectly through negative yields on assets purchased with those deposits — they could actively discourage deposits by cutting interest rates in an already low-interest-rate environment.

Therefore, if banks were hit with negative interest rates on their central bank reserves, the result may not be a healthy surge in lending, but instead the strong likelihood of widespread negative interest rates for corporate deposits.

Corporate treasury impact

Should this situation actually arise, it has important implications for the equilibrium that treasuries strive to achieve across security, liquidity and yield. In times of extreme stress, as seen in 2008 and the recent eurozone crisis, there is a willingness to accept negative rates to avoid the risk of capital loss. Although the current economic scenario is hardly buoyant, confidence is still greater than five years ago. Treasurers' priorities continue to be security and liquidity – although they may be less willing to accept a negative return as a premium for maintaining that.

Nevertheless, and depending upon their currency allocation strategy, some corporate treasuries may opt to sit tight on conventional deposits in view of possible changes in the US. The Federal Reserve has consistently stated that >

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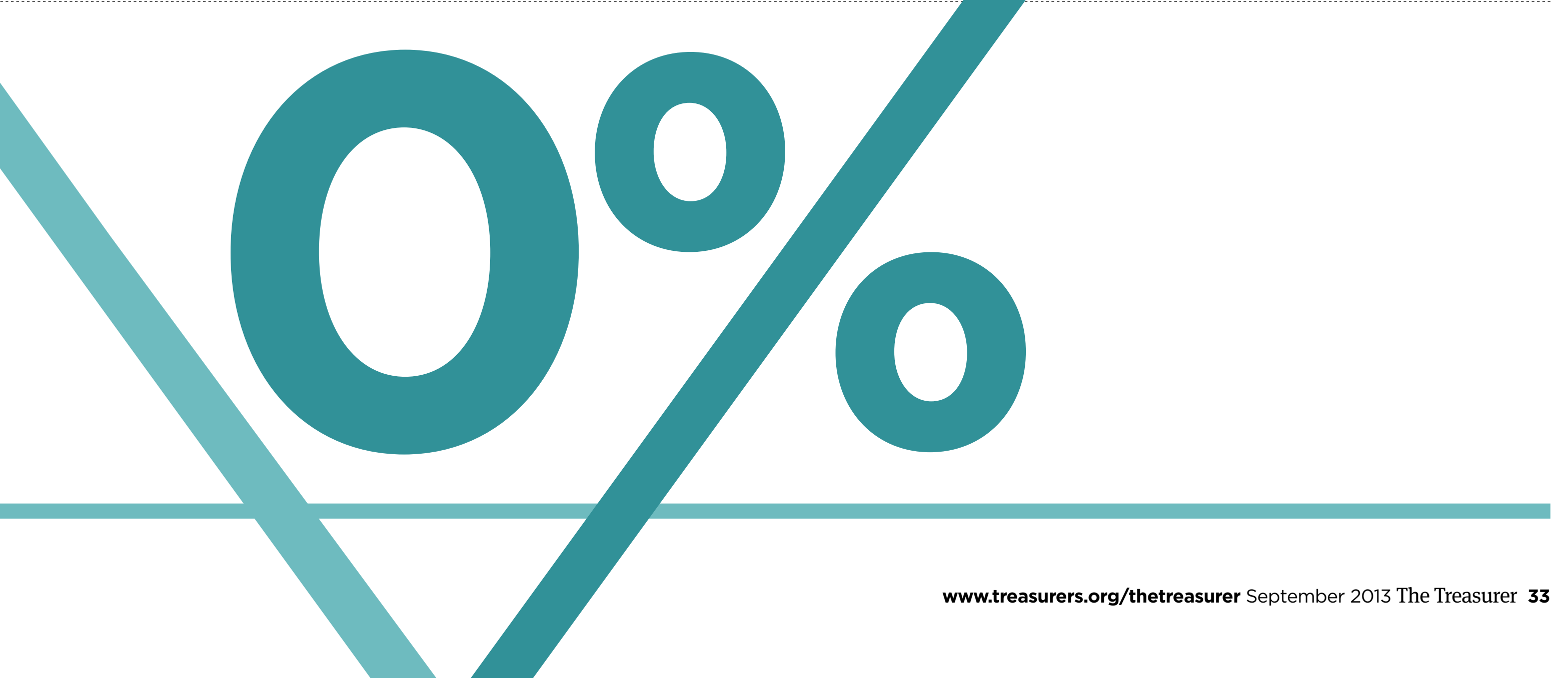


TAKING POSITIVE ACTION

PLANNING

While the prospect of negative returns on deposits is clearly of concern, the good news is that numerous remedies are available – but it is vital to start choosing from these as soon as possible. This is an area where relationship banks can play an invaluable advisory role. Aside from a detailed knowledge of each client's business, they will also be able to offer a market-wide perspective. Points to discuss and consider might include:

- **Is it appropriate to limit operations in negative-interest-rate jurisdictions or certain currencies?**
- **Can relationship banks offer interest optimisation and cross-country enhancement products that can mitigate the impact of negative rates?**
- **Is repatriation or paying down debt a better alternative to holding deposits?**
- **How can negative interest be accounted for in the treasury investment policy and procedures, and how should forecasting be handled for the profit and loss impact?**
- **Is there a need to implement jurisdiction-specific and/ or currency-specific investment policies?**
- **Can the corporate treasury management system handle negative interest?**
- **Could diversifying deposits among more banks enhance yield?**
- **Or could core banking relationships be leveraged to better effect?**

LATERAL THINKING

Looking beyond deposits and related operational matters, there are a number of additional options available as a response to negative rates:

Currency reallocation

One consideration is diversifying the overall percentage of currency allocation. If accepting negative interest rates is seen as inevitable anyway, is there a case for moving cash into perceived safe-haven currencies, such as Swiss francs or possibly Japanese yen, where the negative return may be partially offset by currency appreciation? Obviously, any reallocation of currencies needs to be undertaken in the context of existing FX hedging strategies.

M&A and business expansion

In some cases, M&A activity will ride to the rescue as a means of disposing of at least some surplus cash. But while there are signs of revival here, many corporations (especially in Europe) remain reluctant to acquire assets that may actually be a performance drag while the economic picture remains lacklustre.

Another possibility is to bring forward all or part of existing organic expansion plans. For instance, if the company eventually intends to build a factory in China, is now the time to switch some cash into renminbi? Or perhaps even to purchase a site in anticipation of land appreciation?

Supply and sales chains: a return source?

Supply chain finance activity has seen a huge increase in recent years. In the vast majority of cases, corporations prefer to have a third party (typically a bank) provide the funding, but for those awash with surplus cash, self-funding can generate substantial and predictable returns. Furthermore, where financing is only provided on the basis of approved invoices, the risks are low.

On the flip side, it may also be possible to generate returns from small- to mid-size enterprise customers in a similar manner by formalising the practice of charging interest on late payments. For those concerned with credit risk, an alternative might be to charge a premium over and above the cost of trade credit insurance to reflect any extended settlement terms allowed.

Secondary trade

The redistribution of trade finance transactions has grown dramatically in recent years. While much of this is still conducted on a bank-to-bank basis, a growing number of other financial institutions are also becoming involved. And by the very nature of their role, many corporate treasurers are already well qualified as potential investors in the secondary market for trade finance.

In line with the underlying transactions, these repackaged trade transactions have a predictable life cycle and risk profile. Furthermore, risk can often be tailored to specific appetites since many trade finance redistributions are sliced into various risk/ return tranches.

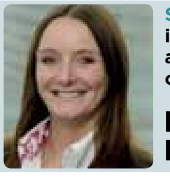
unemployment would need to be around 6.5% in order to support a change in short-term interest rate policy. Assuming that some of the asset purchasing (for example, quantitative easing) will stop between now and that point, it is undoubtedly a milestone in terms of the direction of short-term interest rates there. The Federal Reserve has also left scope within its pronouncements to raise rates sooner or later in light of other factors, such as the state of housing, inflation and consumer spending/confidence.

In general, increasing rates in the US would lead to a strengthening economy and, therefore, appreciation of its currency in the FX markets. This, in turn, could result in an influx (and/or repatriation) of funds to the US, attracted by both strengthening interest and exchange rates.

Drive positive outcomes in a negative-rate environment

Negative rates on corporate deposits are now a very real possibility, but their negative impact is not a foregone conclusion. [See box – Taking positive action, above.] There is a broad range of possible remedies open to treasury, but the key is to start exploring these as soon as possible. This may ultimately result in a blend of strategies that might include interest optimisation, self-funding of supply chain finance, and early execution of existing business strategy.

Relationship bank advisers can help with strategy selection, especially where they can offer a global perspective and broad financial market expertise in the context of understanding the client's business. In a highly challenging environment, a view of the bigger picture can trigger both innovation and returns.



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