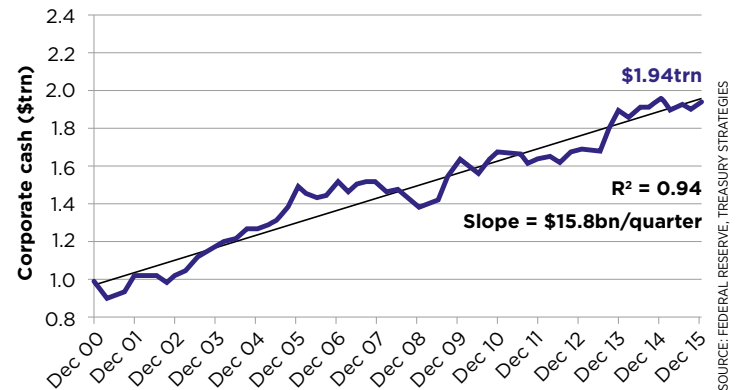


US CORPORATE CASH



SOURCE: FEDERAL RESERVE, TREASURY STRATEGIES

Consider what a great time it is to be a corporate treasurer on this side of the Atlantic. Low interest rates provide you with a great opportunity to build a solid balance sheet; the European Central Bank is rolling out the red carpet for your bonds, even at zero interest rates; inflation is quiet; there is ample liquidity in the markets; banks are interested in lending; the US dollar is relatively strong and stable; the economy is moving along, albeit in low gear; and technology is enabling and empowering you to expand your remit and create even more value for your company.

Now consider what a challenging time it is to be a corporate treasurer in the US. Money market fund (MMF) regulations are narrowing your investment and borrowing options; the Federal Reserve's \$4 trillion balance sheet overwhelms the markets and threatens to blow up even the best strategies on the slightest whim of the governor; regulators, seeing the end of the current US administration, are running their printing presses at full speed, an action certain to create unintended consequences, while Basel III rules are still winding through the banking system with an uncertain, but presumably negative, impact for corporations; the interest-rate picture is not known; and pooling structures are either going away or are priced out of reach.

In this environment, we see our clients, treasurers of large companies, focused on three key areas:

- Accumulating cash;
- Preparing for the MMF regulations; and
- Optimising their use of technology.

Accumulating cash

Cash on the US balance sheets of companies doing business there continues to rise. At

\$1.94 trillion, corporate cash has doubled since the year 2000. At Treasury Strategies, we disagree with pundits and commentators who cite lack of capital spending and a slow economy as the culprit. Rather, we believe that this is a long-term trend in response to uncertainty, concerns about long-term access to credit and a tougher regulatory environment. Treasurers worldwide are simply holding more precautionary cash on their balance sheets.

Fifteen years ago in the US, corporate cash was 9% of GDP. Today, it stands at 11%. In fact, over that period, for every \$1 trillion increase in US GDP, corporate cash increased by \$124bn with an astonishing statistical significance of 0.94.

As we work with corporates, we hear the precautionary theme again and again. Will banks restrict credit once the Fed tightens? Will regulation increase the rate at which public-sector credit crowds out the private sector? Will Basel III and the Volcker Rule make underwriting more difficult and costly? Together, these concerns are driving corporate cash accumulation and we don't see our clients changing that outlook anytime soon.

Preparing for the MMF regulations

On 14 October 2016, after a long battle, MMF regulations will go into full effect. Prime institutional funds will be required to float the

net asset value (NAV) and their boards will be empowered to institute liquidity fees and redemption gates.

These regulations have led to steady outflows since the first proposals in 2010. Assets have fallen from \$1.7 trillion to \$1.2 trillion, mostly flowing into government MMFs. There is speculation that the decline will continue as the effective date approaches. In preparation, many fund managers are shortening their maturities. Some managers are investing very little with maturities beyond October 2016.

Several problems flow from this:

- Prime institutional funds are the market's largest purchaser of commercial paper. With assets shrinking, there are fewer buyers of corporate commercial paper.
- As fund managers shorten their maturities, treasurers are left with issuing shorter-term securities, creating transaction cost and rollover risk.
- As investors, treasurers find themselves relegated to lower-yielding government funds. Some treasurers feel that the combination

All stocked up and nowhere to invest

US TREASURERS HAVE BUILT UP STRONG RESERVES, BUT REMAIN UNSURE ON THE RIGHT CHOICE OF INVESTMENT. ANTHONY J CARFANG ARGUES THE CASE FOR PRIME INSTITUTIONAL FUNDS

of a floating NAV, liquidity fees and redemption gates render prime MMFs a less effective instrument and possibly at odds with the company's investment policies. We have the contrary view that the regulations simply remove some of the clear advantages of prime MMFs and place them on par with other MMF instruments and bank deposits. Consider the three key planks:

Floating NAV – Prime funds had enjoyed a constant NAV of \$1 per share and treasurers loved that. Now they must float. In reality, though, every other instrument in the market that is not held to maturity with absolute certainty also floats continuously. A treasury bill that is sold prior to maturity will have fluctuated in value and created either a gain or a loss for the investor. Ditto commercial paper. MMFs are now simply on par with all other instruments.

Liquidity fees – Again, MMFs enjoyed daily liquidity, even when market stress imposed 'fees' on all other market instruments. Clearly, when an investor sells any other instrument into a stressed market, that investor will incur a haircut, tantamount to a liquidity fee. Similarly, a depositor redeeming a certificate of deposit prior to maturity will forfeit interest or incur other fees, also tantamount to a liquidity fee. MMFs are now simply on par with all other instruments.

Redemption gates – This is probably the most misunderstood market phenomenon. Money markets are generally robust and there are always buyers available to match sellers. Well, not quite. Markets can and do experience liquidity gaps, sometimes severe, in which no transactions take place. The market participants themselves impose the gate. The most significant recent example was the freezing

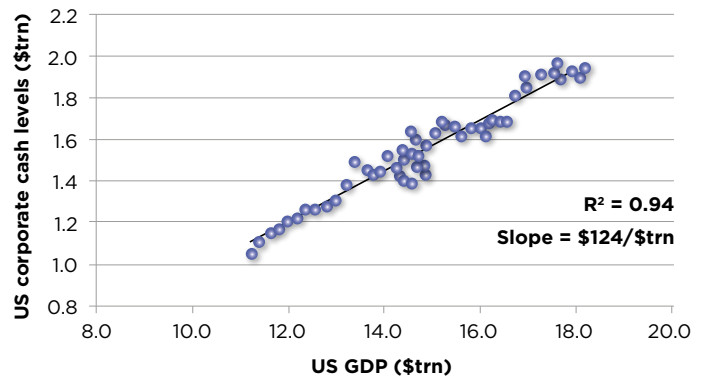
of the auction rate securities market in 2008. Some investors are still unable to sell those securities, effectively experiencing an eight-year gate! Most bank depositors are unaware that, in the event of a bank failure, the Federal Deposit Insurance Corporation is not obligated to immediately repay depositors. Uninsured depositors (most corporations) could conceivably wait for years in the case of a complex resolution.

Treasurers are gradually becoming aware that, from the standpoint of investor utility, prime institutional funds are still the most attractive instrument. We believe that, although assets will continue to decline as we approach the October go-live date, they will rebound quickly and remain the instrument of choice for US treasurers.

Optimising their use of technology

Over the past several years, companies have been very busy upgrading their treasury technology. For most, this meant replacing older treasury workstations or upgrading to newer versions. As these systems grew in power and functionality, many companies underestimated the complexity of the implementations. They became the platform for efficient liquidity management.

US CORPORATE CASH LEVEL RELATIVE TO US NOMINAL GDP



The upshot was that many companies implemented the basics while the more advanced features were postponed until Phase II. Although the core cash management processes were automated and the new technology added value, there remained numerous Excel or other external workarounds.

Many corporate treasuries are embarking on Phase II this year. Companies are implementing modules that had been purchased, but unused. Investment tracking, FX, debt management, cash forecasting and risk management generally top the list. They are improving connectivity with all of their banks, not just a few. They are implementing comprehensive bank account management tools as well. This is a tall order and will keep companies busy well beyond 2016.

Challenges for US corporate treasurers abound. The market has given a temporary reprieve in the form of low rates and a relatively strong dollar. Wise treasurers are taking advantage of this environment to upgrade their treasury systems, improve their business processes and strengthen their balance sheets. 📈



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