Redefining Cash: The Threat of Negative Yield on Corporate Treasury Management

Abstract
Treasury rates may remain at zero or negative levels for a prolonged period and additional banks may begin to charge "extraordinary deposits" fees, pushing depositors back into the money markets. It just may be a matter of time before many, if not most, treasurers are confronted with negative portfolio yield. Private and public sector deleveraging, a languishing economy, the Eurozone debt crisis and the Federal Reserve's recent decision on short-term rates have combined to create this challenging environment. Cash investment objectives may shift from safety, liquidity and reasonable "returns" to safety, liquidity and reasonable "costs." Diversifying holdings among different cash instruments may not increase yield, but it may be a good risk management practice, nonetheless.

Introduction
As the summer of 2011 nears an end, we find ourselves in an era where money under the mattress really might be better than money in the bank! As the Federal Reserve extends its zero interest rate policy into the foreseeable future and the Eurozone sovereign debt crisis shows no signs of abating, the treasury investment management profession also is entering a new and challenging phase. Corporate treasurers must face the prospect of a negative yield environment in which they may have to pay out real dollars for the privilege of sitting on big piles of cash rather than generating investment returns with those assets. How did we get here; what is the likely impact of negative yield on the corporate cash investor; and how do we respond to the challenges of this extraordinary environment? The events of recent weeks, which created much market volatility and anxiety, have left us with no clear answers to these questions. We are forced to rethink the very definition of cash and how to preserve our principal investments and liquidity.

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Negative Yield Invades Cash Accounts
On August 2, 2011, Bank of New York Mellon began telling its largest clients that it would be charging an "extraordinary deposits" fee on balances which exceeded their usual average balances as of June 2011[1]. In its announcement, the bank explained that the step was necessary to discourage "transient" new deposits and to cover costs from regulatory ratios and deposit insurance. This unusual move marked a paradigm shift in the very concept of "cash," since paying a bank to hold non-interest paying deposits overturns the basic finance theory of the time value of money.

In recent weeks, the FDIC's new deposit insurance requirements on bank assets and spreading concerns over the Eurozone sovereign debt crisis caused the yield on short-maturity Treasury securities to oscillate between near-zero and negative levels. At its August 9th FOMC meeting, the Federal Reserve decided to keep in place the current Fed funds target rate of zero to 0.25% for two more years. This decision quickly pushed zero-yielding securities out to the six-month part of the yield curve. As a

result, when transaction costs are included, the net yield on short-term Treasury securities is negative for many investors.

If short-term Treasury rates remain at current levels and if additional banks begin to charge “extraordinary deposits” fees, depositors may return to the money markets in droves, and it’s possible that short-term rates may trend even lower than current levels. In recent trading sessions, we have seen rates on intra-day repurchase agreements (repos) dip below zero due to a lack of Treasury collateral; and if market conditions don’t improve soon, it may be just a matter of time until many, if not most, treasurers encounter negative portfolio yield.

How Did We Get Here?

Private sector deleveraging reduces demand for credit. Rome wasn’t built in day, nor did this yield environment arise overnight. After three decades of solid credit expansion, consumers and companies began to “deleverage” by scaling back their debts in the wake of the Great Recession. For consumers, a portion of the deleveraging was involuntary, resulting from foreclosures and personal bankruptcies. And on the business front, many non-financial companies continued a deleveraging “super-cycle” that arose during the “jobless recovery” of last decade. These debt deleveraging trends ultimately reduced the demand for credit, putting downward pressure on yields of fixed income investments and shrinking the overall supply of money market debt.

Government austerity limits the potential for fiscal stimulus. In a reversal of the globally-coordinated fiscal stimulus employed to combat the Great Recession, governments in much of the developed world now are facing the daunting task of shrinking their bloated balance sheets. Going forward, governments’ limited ability to engage in additional rounds of fiscal stimulus may translate to meager growth expectations and lower bond yields.

Risk of recession has increased. In recent weeks, economic forecasts for growth and payroll gains in the next year have been substantially downsized. USA TODAY’s recent quarterly survey of top economists put the chance of another downturn at 30% — twice the level from three months earlier[2].

Federal Reserve’s decision has anchored rates. The Federal Reserve stated that it intends to hold the target for the overnight lending rate near zero at least through mid-2013. The Fed’s “commitment” has acted as an anchor, prompting the two-year Treasury note yield to drop below 0.20%, and yields on shorter-term credits, including Treasury bills, overnight repos, and agency discount notes, have dipped toward zero or crossed over to negative territory.

Eurozone debt crisis drives cash into safe haven assets. EU leadership remains divided on how best to contain its sovereign debt crisis and investors have sought out safety in the U.S. cash market, further driving down yields. In addition to moving cash into FDIC-insured banking institutions, investors also have “de-risked” by shifting cash away from prime money market funds with exposure to Eurozone banks. Although there are recent indications that some money market funds have regained lost assets,

investors continue to place a very high premium on safety and yield appears to be a distant second objective.

Too Much Cash Creates Headaches

As fearful investors sock away their money in bank accounts, cash has become the fastest-growing asset on bank balance sheets in 2011. From the beginning of the year through August 9th, bank holdings of cash were up 83% to $1.98 trillion, according to the Federal Reserve[3]. But holding cash comes at a high cost to banks. The transient nature of new deposits and the weak state of the economy limit banks' ability to put the cash to profitable use. At the same time, institutions such as Bank of New York Mellon must pay roughly 0.10% in annual insurance fees to the FDIC. Huge deposit inflows also force banks to hold increasing amounts of capital to keep their regulatory capital ratios steady. Compounding the issue, in order to satisfy investors, banks often report their capital ratios under the more stringent Basel III Accord guidelines (even though these rules do not come into effect until 2018).

The practice of charging fees on deposits is unfamiliar to most U.S.-based depositors, but other countries have a history of using negative interest rates to discourage the influx of cash. In 2009, Sweden cut its benchmark interest rate below zero and, in the late 1970's, Switzerland's central bank imposed negative interest rates in order to slow capital inflows that were driving up the value of the Swiss franc. In the same week that Bank of New York Mellon imposed its deposit fees, there were rumors that some Asian central banks also were considering imposing taxes on incoming deposits to reduce the flow of foreign capital into their banking systems.

We think it is likely that other large banks will follow in the footsteps of Bank of New York Mellon by restricting "hot money" deposits if funds continue to flow strongly into banks. Fees on transient deposits and negative yields on Treasury bills may, in effect, push investors into other cash instruments, further depressing yields across the board. If the pressure does not let up, it is not unthinkable that we will see rates on overnight repos, discount notes and non-financial commercial paper move into negative territory, as well. If that happens, cash investment objectives for corporate treasurers may change from safety, liquidity and reasonable "returns" to safety, liquidity and reasonable "costs." Cash investment strategies also may change from those that consider risk and return tradeoffs to those of pure risk diversification.

Diversification Remains the Defensive Answer

We should point out that negative Treasury yields and bank-imposed fees on deposits may be a temporary phenomenon. However, it is imperative that corporate treasurers identify trends in the world of cash investments and have a contingency plan in place. With a great deal of uncertainty on the horizon for both Europe and the United States, investors should be prepared to deal with the worst-case scenario of a prolonged negative yield environment.

Separate facts from fiction. In their zeal to get the story, the financial media may contribute to market instability and investors need to maintain a discerning eye when consuming financial news. Knee jerk reactions to the news by investors often result

from a lack of understanding the risk characteristics of the underlying assets. Investors may develop better risk tolerance when they understand the fundamental credit metrics of their holdings and the key functions served by global financial institutions. Decisions made while in panic mode are unwise unless you have considered all options. For example, not every security within a class will carry the stigma – there may be some stalwarts that continue to perform well and a wise investor will seek out these opportunities.

Assess and adjust liquidity expectations. In times of financial stress, liquidity premiums may increase precipitously. Investors may find it wise to sacrifice some yield potential, by instead building a liquidity cushion sufficiently large to avoid having to access the market when liquidity may be most expensive. In such extremely challenging environments, it is necessary to substitute the cash investment objective of “return on investments” for the “pay to park cash” alternative.

Manage concentration risk sensibly. While it is difficult to fault investors for hoarding cash in non-interest paying bank deposits in uncertain times, corporate treasurers also need to recognize the concentration risk associated with maintaining cash at a small number of large financial institutions. Issuer concentration may be a concern for large treasury accounts as their larger scale and size may limit their options. Diversifying balances among different cash instruments, in addition to exiting bank and money market fund relationships, may expand their opportunities and reduce their exposure to negative yields.

Develop a separately managed account (SMA) strategy by extending maturities. A properly structured SMA strategy may offer an additional arrow in the treasurers’ quivers as a potentially high liquidity risk premium coupled with the Fed’s clear message on monetary policy actually may create yield opportunities for the right treasury accounts. Even though the overall yield curve has shifted downward, securities with strong credit quality that are perceived to be less liquid may offer better yield differential over securities of similar credit quality in the current environment. From an interest rate perspective, the risk of moderate maturity extensions also is lower given the Fed’s stated intention to remain extremely accommodative well into 2013.

Conclusion – A New Era Requires Fresh Thinking on Cash Investments

As companies hold off on investing in new capacity and new jobs, the stockpiling of cash into “safe” securities and bank accounts has resulted in a near zero to negative yield environment. Treasurers need to be aware that portfolio yield may stay negative for a lengthy period, and while doing nothing may seem an easy option, treasurers should take steps to reduce their concentration risk by diversifying among different cash instruments. Even if such moves do not increase their expected yield, they may, nonetheless, be prudent risk management practices.

[1] See PDF file from BNY Mellon Asset Servicing dated August 2, 2011.
http://online.wsj.com/public/resources/documents/BNYcash.pdf

[2] Paul Davidson and Barbara Hansen, Economists outlook darkens: See 30% chance of recession, USA Today Economy Section, August 15, 2011.

[3] See the Federal Reserve's weekly web posting of assets and liabilities of commercial banks in the United States (H8) through August 10, 2011. http://www.federalreserve.gov/releases/h8/current/

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