Three Challenges for Corporate Cash Investors in 2012

Introduction

One short year ago, we discussed three key trends for 2011: low interest rates, a spreading sovereign debt crisis and persistent financial regulation. And we started our 2011 commentary with the phrase, "meet the New Year, same as the old." Have we caught you in a moment of déjà vu?

For 2012, we see these trends remaining very much in place and trying the patience of the fatigued corporate cash investor. We also want to alert our readers to three fresh challenges on the horizon in the New Year. They are: the end of unlimited FDIC insurance for non-interest bearing deposits, the end of supplemental capital support for housing government-sponsored enterprises (GSEs) and the further decline of available money market debt.

We believe the confluence of developing credit risk, the loss of safe havens, regulatory uncertainty regarding money market funds, declining money market supply and the low yield environment call for strong in-house cash investment strategies, including separate account management.

The End of Unlimited FDIC Deposit Insurance

Of the three challenges facing corporate treasurers, we think that the end of unlimited FDIC insurance for non-interest bearing deposits has the greatest potential to dramatically alter the supply and demand dynamics of corporate cash management. As credit concerns mounted, yields dropped and faith in money market funds diminished, corporate treasurers in recent years decided to defer investment decisions and opted to park cash in FDIC-insured accounts. With that insurance expiring soon, bank credit concerns and decisions on how and where to best redeploy the cash once again will confront corporate treasurers.

Note that the earnings credit rates (ECRs) of up to 0.50% on some non-interest-bearing accounts have been more attractive than the sub 0.10% earned on money market funds for much of 2011. Although the ECRs, essentially fee rebates against charges on banking services, have been declining in recent months, the yield advantage and their risk-free nature provided enough incentive for some treasurers to choose bank checking accounts over other cash alternatives. But, with the pending expiration of the unlimited FDIC deposit insurance, corporate depositors will need to assess the ECRs as rates of return on stand-alone bank credits.

The Federal Deposit Insurance Corporation's full deposit insurance for non-interest bearing accounts (above the previous $250,000 limit) began in October 2008 after the collapse of Lehman Brothers[1]. Originally scheduled to end by year-end 2009, the program first was extended to June 30, 2010, and was later extended again to December 31, 2010. Then, the Dodd-Frank Deposit Insurance Provision kicked in, further extending deposit guarantees to December 31, 2012[2].

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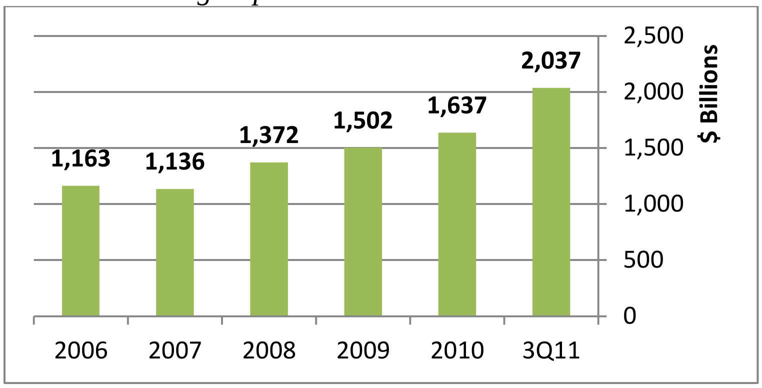
Figure 1: Non-Interest Bearing Deposits at U.S. Commercial Banks



Source: data from FDIC's statistics on banking webpage www2.fdic.gov/sdi/sob

As Figure 1 indicates, non-interest bearing deposits at U.S. commercial banks increased by $901 billion from year-end 2007 through the third quarter of 2011. Considering that U.S. nominal GDP grew only 6.5% over the same period, it is safe to assume that much of the growth in deposits was the result of people seeking the safety of FDIC protection.

We trust that corporate cash investors are well aware of the dangers of uninsured bank accounts. In addition to potential Eurozone debt contagion and the effects of a weak economy on domestic bank credits, reduced assumptions for government support has resulted in rounds of bank ratings downgrades. Without government insurance, uninsured bank deposits may be vulnerable, and a substantial portion of the $901 billion in new deposits may need a new home. Since money market fund regulation remains in limbo, investors must explore other investment choices and, in many cases, they must do it before 2012 comes to an end.

We further think that it is ill-advised to hold out hope for an extension of the current deposit guarantee program. As noted earlier, the current unlimited insurance is part of the 2009 Dodd-Frank Wall Street Reform Act and that legislation is beyond the authority of the FDIC. Barring catastrophic events threating the stability of the U.S. banking system, we doubt that Congress will reach consensus to reauthorize the program.

GSE Capital Support Less Certain after 2012

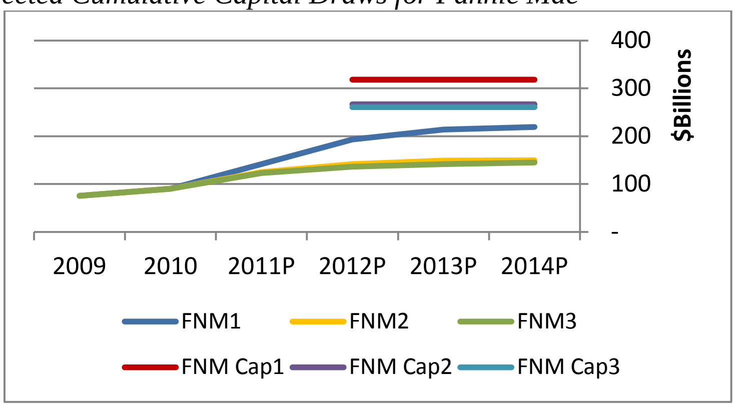
As we wrote in April 2011, the expiration of the Treasury Department's second amendment to its capital support agreements with Fannie Mae and Freddie Mac understandably will create some concerns for investors. At a minimum, the government's support for the GSEs will switch from a "blank check" policy to a policy of finite resources after December 2012 and this shift will demand ongoing monitoring of the GSEs and their credit profiles.

This is a very important matter, as short-maturity GSE debt has provided safety and reasonable yield for investors seeking safe harbor from the uncertain world of unsecured financial issuers since the credit crisis. As 2012 wears on, the safety net supporting GSEs may become less secure in the minds of some, especially with respect to longer-duration GSE issuance.

Please note that the expiration of the government's second revision to its capital purchase agreements on December 31, 2012, does not mean the end of its support for the GSEs[3]. The Treasury Department remains the conservator for Fannie and Freddie with 80% effective equity ownership. The government also remains committed to the unused portion of the original $200 billion each was stipulated in the first amendment in May 2009. According to official documents, after December 2012, the available capital funding for Fannie will be $124.8 billion and $149.3 billion for Freddie, assuming neither firm is profitable by then[4].

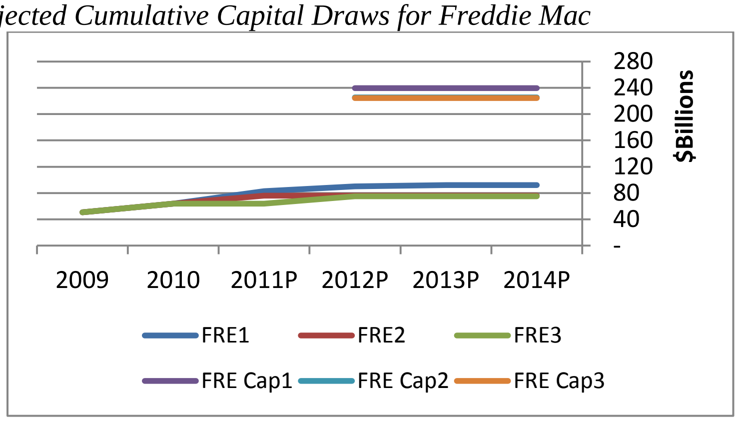
We modeled this available funding against the agencies' projected capital needs through 2014 in Figure 2 and in Figure 3, with data from their regulator, the Federal Housing Finance Agency (FHFA)[5]. The FHFA's projections were based on three economic scenarios occurring between 2011 and 2014. We added $124.8 billion and $149.3 billion to projected capital draws through December 2012 to represent maximum capital thresholds. The figures tell us that, even with the most severe economic assumptions, potential capital needs at both GSEs fall below the projected caps, at least through 2014.

Figure 2: Projected Cumulative Capital Draws for Fannie Mae



Sources: FHFA Conservator's Report and Fannie Mae's 10-Q report

Figure 3: Projected Cumulative Capital Draws for Freddie Mac



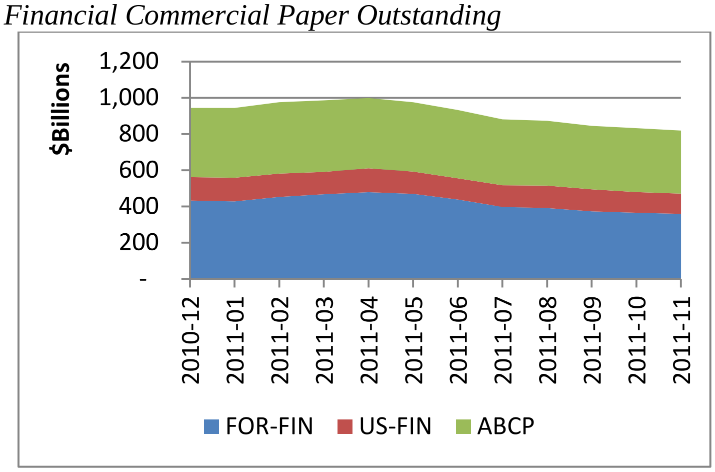
Sources: FHFA Conservator's Report and Freddie Mac's update report

To restate the position voiced in our April 2011 article, it is our strong belief that senior short-duration GSE debt will continue to enjoy a very high level of government support after 2012. The analysis on the undrawn capital relative to projected capital needs further illustrates this point. However, as capital resources no longer are unlimited after 2012, GSE analysis also will become more nuanced and complicated and it will require more thorough investor attention and rigorous credit analysis.

Smaller Market for Financial Debt

The trend of declining demand for financial debt in the money markets entered its fifth year in December 2011 and coincided with further deleveraging of bank and household balance sheets. The recent flare up of the Eurozone sovereign debt crisis accelerated the decline as the underlying causes of the crisis became clear: too much sovereign debt, too much bank debt, interconnections between governments and banks and a complex political structure bound by unanimous consent. In a market traditionally dominated by European financial issuers (see our June 2010 article: European Financial Debt and U.S. Prime Money Market Funds), U.S. money market funds steadily weaned themselves off debt issued by Irish, Spanish, Italian and, now, French banks throughout 2011. The result is a smaller overall market for financial debt.

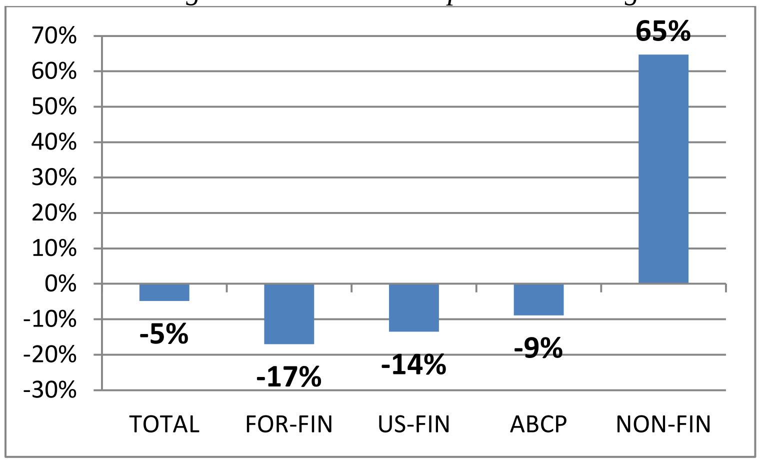
Figure 4: U.S. Financial Commercial Paper Outstanding



Source: Federal Reserve Board commercial paper download web page

Figure 4 shows that, except for a temporary upward trend in the spring of 2011, a long-term trend of declining commercial paper issuance has been established. Through November, the market saw an overall decline of 13% in financial debt issuance, led by a $73 billion (-17%) decline in foreign financials. Please note that the loss of market access by European financials was partially offset by increased issuance from Australian, Canadian and Japanese banks. U.S. financial paper and outstanding ABCP issuance also declined by $17 billion (-14%) and $33 billion (-9%), respectively.

Figure 5: Year-to-Date Changes in Commercial Paper Outstanding



Source: Federal Reserve Board commercial paper download web page

When we graphed the year-to-date changes including non-financial commercial paper outstanding (in Figure 2), an astonishing pattern emerged. Outstanding issuance in non-financial commercial paper surged $73 billion (65%), almost exactly replacing the declining foreign financial balances. We believe this is an important trend to recognize and observe, and it may represent a paradigm shift in short-term debt financing.

In 2012, money market investors may continue to steer clear of debt from all but the few large and systemically important financial institutions. Recent bank ratings downgrades and lower assumed levels of government support also may encourage creditworthy corporate borrowers to issue debt directly, as the cost may be lower than that offered by banks with lower credit ratings. Firms with healthy profit margins and robust balance sheets also may find the current low yield environment favorable for pre-funding their financing needs or even refinancing stock buybacks. In short, we believe the diverging trends of financial and non-financial debt issuance will continue, which may provide much needed relief for corporate investors looking for safe havens besides U.S. government securities.

Conclusion: Trends in 2012 May Compel Investors to Consider Separate Accounts

With the fate of the euro uncertain and the Fed on hold for the foreseeable future, corporate cash investors have few options available to keep their cash safe and liquid in 2012. The expiration of unlimited FDIC deposit insurance may prove most painful for treasury managers looking for easy ways to park cash and enjoy ECRs. Excessive caution regarding GSE debt which matures after 2012 also may eliminate another easy resource, even though projected capital reserves remain adequate. But as financial institutions continue to deleverage, willingly or unwilling, a ray of light is seen in increased supply of non-financial debt.

When these challenges are considered with the possibility of more stringent money market fund regulations, we think the corporate treasury community will become more receptive to separately managed account strategies (see December's article) in 2012. Rather than relying on commingled asset strategies with inflexible risk oversight and limited yield potential, investors may benefit from customized separate account strategies combining risk control, liquidity management and yield enhancement.

Separate account solutions require more commitment, knowledge and planning, but ultimately may prove to be a more lasting solution than other choices. Doing nothing while easy options are slipping away no longer may be prudent given today's, and tomorrow's, expected environment.

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[1] See the FDIC announcement on Temporary Liquidity Guarantee Program on October 15, 2008. http://www.fdic.gov/news/news/financial/2008/fil08103.html

[2] See the FDIC's Frequently Asked Questions regarding the Dodd-Frank Deposit Insurance Provision, last updated on August 9, 2012. http://www.fdic.gov/deposit/deposits/unlimited/implementation.html

[3] See the Treasury Department's amendment document dated December 24, 2009. http://www.fhfa.gov/Default.aspx?Page=364

[4] Numbers are taken from Fannie Mae's 3rd quarter 2011 Form 10-Q, page 67, and Freddie Mac's "Freddie Mac Update," dated December 2011, page 6, available on the respective agencies' websites.

[5] See Federal Housing Finance Agency's "FHFA Updates Projections of Potential Draws for Fannie Mae and Freddie Mac" released on October 27, 2011 on the agency's web site. http://www.fhfa.gov/webfiles/22738/GSEProjF.pdf