Treasury Trends

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Managing excess cash in a low interest world

Banks are continuing to respond to the plentiful supply of funding available at low rates by reducing deposit rates, meaning achieving a 'reasonable' rate of return on corporate cash held at the bank is getting harder. Over the past year or so, interest rates for new term deposits have declined by more than 100 basis points, to the lowest level on record, while rates for at-call deposits have declined by around 50-75 basis points. Facing limited demand for new business lending and with banks now able to access low cost funding directly from the central bank, the need to attract new funding by banks has reduced.

At the same time, and despite the low interest rates being offered by banks, deposit growth has been strong. Domestic deposits now make up roughly 60% of Australian bank funding, up from 55% a year ago, while a similar lift has been seen in the New Zealand banking sector.

Close to zero

Corporate transactional accounts and overnight investment accounts (money market accounts) are generally based off the Cash Rate, usually at a discount or premium to this benchmark rate and are often individually negotiated with the bank. This might look something like 'OCR minus 0.50%', or 'RBA cash rate plus 0.10%', with tiered interest rate structures also popular with those who regularly hold larger liquidity positions.

Unlike some parts of Europe, where corporates can be penalised for holding excess cash at the bank, banks in this part of the world have so far taken a 'zero floor' approach to their interest calculations. This avoids any controversy over charging those corporates which have funds on deposit – even if the agreed credit interest rate on the account is, say 'OCR minus 0.50%'.

While we do not see this 'gentlemen's agreement' changing any time soon, it may be a timely prompt to review liquidity management and wider transactional banking arrangements. Our detailed work in this space often identifies significant cost savings and process improvement opportunities, particularly for those corporates with less than optimal liquidity management structures.

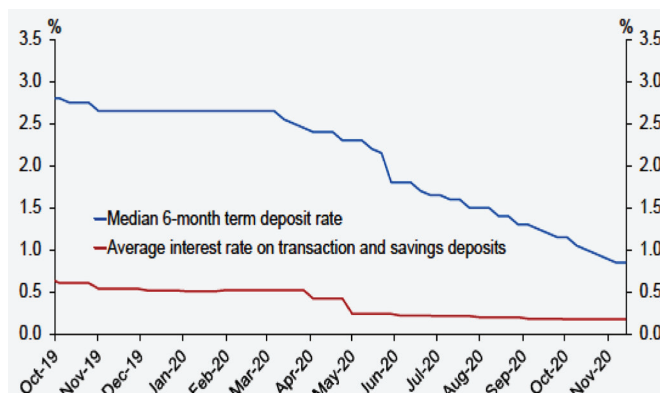
While banks have so far sidestepped the indignity of charging those with surplus cash for holding their funds, this is not to say that corporates and others have avoided the sting that has come from low interest rates and a general lack of institutional appetite for deposits.

The harsh reality of low interest rates has left organisations hunting for higher yields on cash balances, either by extending duration or accepting greater credit risk in exchange for higher yields. Investors therefore need to ensure that they remain comfortable with their assessed risk tolerance and that maximum investment maturity and minimum counterparty credit ratings are appropriately stipulated within the appropriate investment or treasury policies.

Consideration must also be given to liquidity needs and the need for flexibility, as term deposit funds are typically locked in and can only be accessed in limited circumstances.

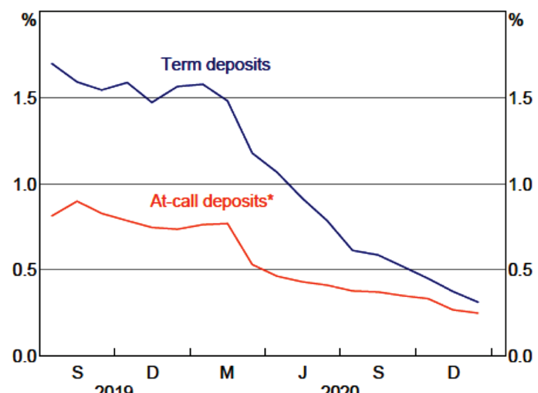
(Continued on page 2)

NEW ZEALAND - DEPOSIT RATES FOR FIVE LARGEST BANKS



Source: interest.co.nz, Reserve Bank Income Statement Survey

AUSTRALIA - BANKS' DEPOSIT RATES FOR NEW FUNDING



*Excludes deposits in housing loan offset accounts, includes non-interest bearing deposits. Source: ARPA, RBA

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Lessons not being learned

The recent demise of Greensill Capital has sent shockwaves around financial markets and not least in around 20 German towns/municipalities which had, together, deposited EUR250m+ with the banking part of the group (Greensill Bank). Under German law the municipal holdings of institutional investors are not protected by a deposit guarantee which still exists for individuals, leaving the towns open to loss of capital (some, or all). Pending final investigations, it would be fair to assume counterparty limits, investment concentration etc., will be in question — and the search for blame will get ugly.

The purpose of good governance, policy and strategy (backed by sound reporting and review processes) is to provide comfort through both normal and 'unprecedented' times. As financial markets recover, for example post GFC, the lessons learned tend to be confined to history … until the next time.

New products

Experienced investors will view cash as meaning cash. If it isn't cash, it isn't! A number of 'cash' products have been released in recent times, which is unsurprising given the low interest rate environment, but be cautious to fully understand the make-up of such products.

In one example we were asked to comment on, the cash element of the product was only 3%, the remaining 97% being made up of a combination of various investments (bonds, hybrids and securities), across a range of rating classes (some well below investment grade).

Whilst the interest rate being offered was 'attractive', the challenge was in trying to equate the rate with the amount of risk taken. In other words, recognising how far up the risk curve this product was, what that risk should be priced at to be 'fair' and, most importantly, whether the risk/reward on offer suited the investor. More so given that the objective was to invest in cash.

This is not to say an investment strategy should not include 'new' offerings, but it's a reminder to ensure that they are worked through methodically and tested against the overriding objectives of the asset class and allocation.

Stop the clock, time to review

Our investment consulting team can attest to the legwork currently being deployed in reviewing investment strategy and governance frameworks, and the resetting of benchmark return expectations to reflect the new 'normal'. With capital preservation being the underlying requirement for most, it is always important that investors ensure that investment products suit their needs, and that the underlying risk profile is properly understood.

For many, there is a heartfelt and long-standing 'conservative' investment philosophy that has now delivered them to a point of almost zero nominal (and negative real) returns, which are unsustainable given wider strategic objectives. It's okay to be conservative but the pros and cons of this approach need to be understood and reviewed from time to time. As past performance is no guarantee of future performance, historical and/or untested investment policies and mindsets are no guarantee, either.

If not formally reviewed in recent times, current market conditions provide a prime opportunity for revisiting investment fundamentals such as:

- What are the stated objectives of the investment pool/s? Are they still current?
- Is the investment horizon of the funds clear? (razor sharp cashflow forecasting and confidence to be able to place funds across a variety of terms is key here).
- Given answers to these and other questions, does the Investment Policy Statement still reflect the organisation's risk appetite and investment objectives?

Investment governance workshops

We are currently assisting a number of groups with investment governance workshops where these and other investment issues are being teased out. It is not necessarily an easy task having disparate fiduciaries agree on investment objectives, performance benchmarks and investment horizons but we believe it is important that whatever investment objectives and risk profile an organisation assumes, that it is a considered decision and not just one that has worked in the past and is rolled forward ad infinitum.

There is no 'one-size fits all' solution to address the challenges of low interest rates but given the continuing macro-economic backdrop, it is apparent that the challenges corporate treasurers face in earning a return on excess funds will persist for some time.

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