June 30, 2016

The Honorable Jacob Lew
Department of the Treasury
c/o Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington, DC 20044
Attention: CC: PA:LPD:PR (REG-108060-15) Room 5203

Re: Proposed Treasury regulations under Section 385

Dear Secretary Lew:

Treasury Strategies, a division of Novantas, Inc. is pleased to share our concerns regarding the proposed regulation (REG-108060-15). Treasury Strategies is the acknowledged leader in treasury, liquidity and payments issues. These are precisely the areas that are impacted by this proposal. For 34 years, we have consulted with corporations, municipalities, and financial services providers in the U.S. and around the world on these topics. Our parent, Novantas, Inc., is the industry leader in analytic advisory services and technology solutions for financial institutions.

In addition to sharing our insights via this letter, we would be pleased to testify to these and other points at your upcoming July 14 hearing.

We recognize that it is the objective of this administration and the Department of the Treasury to reduce U.S. corporate inversions. However, as written, this proposal goes well beyond that objective and reaches thousands of U.S. businesses. We believe that it certainly is not the intention of Treasury to disrupt the routine daily business practices and systems of virtually every medium-sized and large U.S. company.

This letter shows how the proposal will impact so many U.S. companies, the banking system and the economy as a whole. We close by offering specific suggestions to remedy the situation.

Our letter demonstrates that:

1) The rules go far beyond the scope of corporate inversions and potentially impacts most mid-sized and large American businesses, increasing their costs and reducing their capital efficiency.
2) The rules will decrease lending to America’s businesses and consumers by forcing commercial banks to incur higher capital requirements, and an increase in “high quality liquid assets” (HQLA) required under Basel III.
3) The rules will add a further drag to an already sluggish and uncertain U.S. economy. U.S. capital efficiency, already in decline, will fall further. Corporations will set aside additional capital to fund routine transactions rather than risk tripping a violation of these far-reaching rules. Banks will then need to set aside more capital and HQLA to support the increase in corporate deposits. Together, this additional stranded corporate and bank capital will depress economic activity.

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We believe it was not the intention of these rules to deter nor completely eliminate many routine cash management activities. These practices have been commonplace among thousands of U.S. businesses for over forty years and help companies grow, operate and invest. In fact, many of the leading corporate treasury principles that would be impacted are the very same principles that underpin the U.S. Treasury's own cash management systems.

Background

Since the 1970s, mid-sized and large companies, both in the U.S. and worldwide, have adopted efficient cash management structures.

Most companies collect their revenues as close to their customers as possible. These can be cash and checks collected in stores, mailed payments at regional collection facilities known as lockboxes, at branch offices or at point of sale using credit cards. Companies then upstream all of that cash daily into a centralized concentration account, the corporate cash pool. Accounting and treasury technology keep track of the intercompany details.

On the disbursement side, most companies pay their vendors and employees either by check or electronically from that same centralized concentration account. Generally, each business unit maintains its own payables accounts which are funded daily from the corporate cash pool as checks or electronic debits clear. Payroll is handled in a similar fashion. Again, treasury technology tracks the details.

For companies with many subsidiaries, it's often the case that subsidiaries buy and sell raw materials, supplies and finished goods from each other. These intercompany payments can be netted within the company's treasury system. They settle internally and never actually enter the banking or payments system – reducing risk, improving efficiency and generating additional liquid capacity for the economy.

For global companies, the process is similar. With the help of sophisticated transaction banking services and technology, companies can replicate this structure across countries and across currencies. In fact, systemic risk is greatly reduced, because companies and their banks are able to net many of these transactions internally without even entering the payments system.

As a result of these cash management structures, the amount of cash a company must tie up in its daily collections and disbursements is minimized. Cash reaches its highest and best use when it is aggregated and deployed very quickly and efficiently. Over the past three decades, Treasury Strategies has assisted hundreds of companies in achieving cash optimization by applying these time-tested principles.

Adverse Impact on Corporations

As currently proposed, the rules go far beyond the scope of corporate inversions and potentially impact most mid-sized and large American businesses.

The cash management principles described above allow a company to centralize its cash into a single pool where the cash can achieve its highest and best use. On a daily basis, business units with excess cash “lend” that cash to units that are short on cash. In many companies, there are dozens of such intercompany loans each day. In large companies, there are hundreds. Most of these loans resolve themselves the following day.

Rule 385 gives the IRS broad powers to unilaterally reclassify these loans as equity rather than debt – with onerous tax consequences. The rule even gives the IRS the power to create a new security by reclassifying some routine intercompany loans as a debt/equity hybrid. Without going into the details, there are dozens of potential technicalities in the proposed rule which collectively are likely to trigger a reclassification and unfavorable tax consequence for even the most risk-averse company.

To compound the problem, the rule provides a three-year look back and look ahead provision for these trip wires. Thus, that first accidental trip will most certainly cascade and infect the company’s entire cash pool with draconian tax consequences.

Based upon our direct consulting experience with corporate treasurers and CFOs, we believe that companies will be very risk-averse to having any debt reclassified as equity or hybrid under Rule 385. The tax penalty resulting from the reclassification is just too onerous. Therefore, companies will undertake two burdensome and costly steps to avoid any risk of non-compliance:

1) Companies will restructure their cash management systems to avoid any comingling of funds between business units within their corporate group. That will require realignment of their banking structures and retooling of their treasury management or enterprise systems. These costs may range from a few thousand dollars for mid-size companies to $1-10 million each for larger or more global companies.

2) Companies will need to raise more capital in the form of either debt or equity. Since businesses within a corporate group will avoid intercompany lending, each business will be required to replace that access to intercompany funding with external capital. Although difficult to determine, let’s conservatively assume that companies will require an extra cash buffer equal to just one week’s revenue. Using that metric, Fortune 500 companies alone would need to raise $230 billion of additional capital without any commensurate increase in earnings.

Adverse Impact on Commercial Banks

Commercial banks which finance and facilitate payments and commercial transactions will be burdened with:

1) Loss of a stable, low-risk revenue stream
2) A more volatile deposit base
3) Higher required capital levels
4) Additional Basel III requirements to hold more "high quality liquid assets" (HQLA)

The net effect is that there will be less capacity for banks to make loans to America's businesses and consumers.

As companies restructure their cash management systems and move away from more sophisticated transaction banking services, commercial banks may face a drop in fee income. Fees from cash concentration, pooling and netting services and the supporting information services will decline. This is unfortunate given that this stream of banking revenues is one of the most stable and least risky of all bank revenue streams. Furthermore, companies will most likely establish lines of credit in each country and currency, which will diminish U.S. banks' role in financing working capital in favor of foreign banks.

Critically important, these cash pools create stable deposits that provide significant liquidity benefits to banks and risk reduction to the financial system. Disaggregating central cash pool deposits into more volatile components reduces the stability of a bank's deposit base, thereby reducing the value of the deposit and introducing funding risk.

An additional significant adverse impact relates to Basel III capital and liquidity requirements. As previously mentioned, we estimate that Fortune 500 companies alone might need to hold $230 billion in additional short-term cash on their balance sheets. Much of this will end up on bank balance sheets in the form of demand deposits.

1) Capital – Under Basel III, depending on which banks receive these deposits, additional bank capital requirements would be in the range of $18-20 billion.

2) Liquidity – Again, under Basel III and depending on the specific banks, banks would have to hold additional liquid assets in excess of $100 billion. This additional demand for HQLA will put further stress on these high-demand assets,[1] depressing returns to the bank and reducing assets available for lending to consumers and businesses.[2]

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[1] "Are There Enough T-Bills to Meet New Regulatory Requirements?" https://www.youtube.com/watch?v=48Sz5GbcFPs

[2] "Collateral Scarcity: An Approach to Preventing Market Stress From Becoming Contagion" illustrates the potential stress. http://treasurystrategies.com/sites/default/files/TSI_CollateralScarcityJuly2015.pdf

The ultimate impact to banks is therefore somewhat lower fee income against a higher capital base, resulting in a lower return on capital, a less stable deposit base and a diminished role in financing U.S. corporations, since working capital loans will be provided at the local country level.

Adverse Impact on the U.S. Economy

U.S. capital efficiency, already in decline, will fall further. Corporations will set aside more capital to fund their routine transactions rather than risk triggering a violation of these far-reaching rules. Banks will need to set aside more capital and HQLA to support the new level of corporate deposits. Together, this additional stranded corporate and bank capital will be a drag on economic activity.

Each quarter, Treasury Strategies conducts its Quarterly Cash Briefing[3] for our business and banking clients around the world. At our April, 2016 briefing, we reported that cash on the balance sheets of corporations doing business in the U.S. at the end of 2015 was just under $2 trillion, or 10.7%, of GDP. That was up from 9.5% of GDP in 2008. In other words, cash became 13% less efficient over that period, because it took 13% more cash to support a given level of GDP than required in 2008.

Adding an additional $230 billion of cash would result in corporate cash levels growing to over $2.2 trillion, or 12%, of GDP. This further reduces capital efficiency and impedes U.S. economic growth.

Conclusion

In its attempt to thwart a small number of large corporate inversions, the proposed Rule 385 unintentionally entraps thousands of mid-size and large U.S. companies.

U.S. companies, unable to put in place efficient cash management structures, will incur expenses ranging from a few thousand to a few million dollars per company in redesigning and realigning their banking and treasury systems. In addition, they will have to hold additional idle cash on their balance sheets; we estimate $230 billion in additional cash requirements for the Fortune 500 companies alone. Competitors headquartered elsewhere will not have the same burden and thereby will enjoy a lower cost of capital and a huge competitive advantage.

U.S. banks could see a decline in their stable fee-based revenues and an increase in their capital and HQLA requirements. They could also, as a result of higher HQLA, have fewer assets available to lend to U.S. consumers and businesses.

[3] http://www.treasurystrategies.com/content/treasury-strategies-quarterly-corporate-cash-briefing™-—-april-2016-1

In short, this unintended consequence has major negative economic outcomes for America's businesses, our banks and the U.S. economy as a whole. Surely this result was not Treasury's intention.

A Path Forward

Treasury Strategies proposes that Rule 385 be drafted more narrowly to avoid these draconian unintended consequences. The new draft should:

1. Enumerate the cash management principles we outlined above as being outside the scope of 385.
2. Define a specific safe harbor for companies so that they will not need to take extreme measures to avoid accidentally triggering a reclassification.
3. Eliminate the three-year look back and the three-year look ahead for transactions that take place solely within a corporation's operating cash pool.

Thank you very much for your consideration of these points. Again, Treasury Strategies would be pleased to testify to these and other related issues at your July 14, 2016 hearing.

Respectfully submitted,

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Managing Directors
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