Treasury Strategies

The Power of Experience®

Managing the Unknowns
A U.S. Corporate Treasury View

There can be no doubt that today, corporate treasurers around the globe have major challenges: slow economic growth, fallout from Basel III, foreign exchange volatility and financial crisis regulatory overhang. Treasurers doing business in the U.S. face all these, as well as several issues unique to the U.S. market:

- Rising domestic interest rates
- New money fund regulations
- Collateral scarcity
- Reduced market liquidity
- Corporate tax rate imbalances
- Strong dollar
- Eventual unwind of the Federal Reserve's swollen balance sheet

In our consulting work, we see U.S. treasurers responding to these challenges in several ways:

- Expanding staff; doing more with more
- Optimizing technology
- Focusing on cash forecasting
- Updating policies and centralizing control

The Challenges

- Rising Domestic Interest Rates
- New Money Fund Regulations
- Collateral Scarcity
- Reduced Market Liquidity
- Corporate Tax Rate Imbalance
- Strong Dollar
- Unwind of The Federal Reserve's Swollen Balance Sheet

Rising Domestic Interest Rates

After nearly a decade of virtually zero interest rates, suddenly the cost of USD borrowing is rising. The opportunity cost of suboptimal USD investing is also rising. To make matters worse, higher "Too Big To Fail" capital requirements are leading to lower deposit and earnings credit rates at big U.S. banks. This is all against a backdrop of lower and even negative deposit rates outside the U.S.

Thus, a treasurer must make a host of unfamiliar decisions. Borrow long? Invest short? Reach for yield by reducing credit quality, or improve credit quality without forfeiting yield? Take some FX risk and convert investable cash to USD?

New Money Fund Regulations

On October 14, 2016, institutional prime funds must move to a fluctuating net asset value. Several hundred billion to a trillion dollars may leave prime funds in favor of other investments. No one really knows how much will leave, nor whether the outflow will be temporary (think Y2K). Since funds can invest in maturities of up to thirteen months, we are already within the window of impact.

This poses two dilemmas for the treasurer. As an investor, should the company stick with prime funds, maintaining yield but giving up some liquidity on the implementation date? If not, where should the funds be invested or deposited? Banks certainly have little appetite for new deposits. How much yield is the treasurer willing to forego?

As a borrower, if prime funds shrink dramatically, companies will lose an important source of short-term credit. That's because money funds will have fewer dollars to buy their commercial paper. Some treasurers are already looking at diversifying funding sources, even at a premium.

Collateral Scarcity

As Treasury Strategies has argued throughout the regulatory debate, cumulative effects of myriad new mandates contain seeds of the next debacle. Recently we've pointed out that additional statutory demand for high quality liquid assets at banks and trading collateral at clearinghouses could easily outstrip supply. This is acute in the U.S. because, unfortunately, the new regulations are pro-cyclical and demand will increase exponentially at the first sign of market stress.

This scarcity has a direct impact on U.S. treasurers. Cost of hedges and other derivative risk management tools will rise and availability will decline. Treasurers are upgrading financial models to determine which hedges have become cost ineffective, and explaining to their Boards why they may now leave some exposures un-hedged. Their challenge is determining how much risk the company should keep on its own books.

Reduced Market Liquidity

Dodd-Frank, in particular the Volcker Rule section, limits the role of banks as market makers. This, in turn, creates a drag on underwriting for all but the most creditworthy borrowers. Dealer inventories have fallen to a generational low. Bid-ask spreads have widened considerably, reportedly for some bonds at an unimaginable 10%. These aberrations have even spilled over into the treasury market.

U.S. treasurers have long enjoyed the world's broadest and deepest capital markets. Regulation is now changing that. Treasurers are actively recalibrating processes in anticipation of not being able to access capital markets as readily as in the past.

A treasurer must make a host of unfamiliar decisions.

Corporate Tax Rate Imbalance

The U.S. has one of the highest corporate tax rates in the world, exacerbated by additional tax due when overseas cash is repatriated. As a result, huge amounts of cash are stranded in some jurisdictions, even as a company must borrow in others.

The U.S. treasurer must first ensure that overseas cash is put to its highest and best use, within tax code constraints. In addition, the treasurer must optimize a consolidated balance sheet in which investments and borrowings are both artificially inflated by this cash immobilization. Finally, at some point this balance sheet stretches historical financial leverage ratios, and could inadvertently violate credit covenants.

Strong Dollar

The appreciating dollar leads to more challenges. Are sales forecasts still accurate and, if not, should cash and other balance sheet forecasts be modified? How will it affect cost of goods sold, and how will that affect supply chain financing arrangements? How will it impact the company's domestic or foreign customers' credit quality?

These are murky waters to navigate, requiring deep understanding of each line of business, each geography and appropriate analytics for simulations and stress tests.

Unwind of The Federal Reserve's Swollen Balance Sheet

If there is one wild card for U.S. treasurers, this is it. Most treasurers see this as a dark cloud that greatly increases market risk.

The Fed's balance sheet has grown from $1 trillion to $4.5 trillion over seven years, funded by excess bank reserves that have skyrocketed from $40 billion to $2.5 trillion. What will happen to the markets as the Fed unwinds? What will happen to liquidity and access to credit when bank reserves decline? These transitions may cause wide price swings and liquidity gaps in a whole range of financial assets.

Unlike the other issues mentioned, this one has no precedent and no proven empirical assessment methodology. It's an exogenous risk that the treasurer must manage.

How U.S. Corporate Treasurers are Responding

Doing More With More
After the financial crisis, companies faced tight budgets, but treasury was generally spared the axe. CEOs and Boards came to recognize the strategic value of treasury. Increasingly, treasury has become the financial nerve center of the firm and is being resourced appropriately.

Given all the complexities discussed above, our clients are building their teams. With an expanded remit, they are adding staff who can navigate global markets, manage risk and handle complex analytics – all in addition to the daily blocking and tackling that has always been part of treasury.

Optimizing Technology
Treasury technology has improved immeasurably over the past decade. Rather than standalone systems, treasurers seek solutions that can integrate into other corporate systems and provide insights and analytics to enhance shareholder value.

Companies still using spreadsheets are quickly abandoning them, as auditors and cyber security groups raise red flags.

Even so, most companies using treasury management systems still have much work to do. They have generally done a good job with bank connectivity and cash visibility. Now, they are moving on to higher order analytics and modules such as hedge accounting, risk management, in-house banking and cash forecasting.

Focusing On Cash Forecasting
For several years of zero interest rates, the opportunity cost of bad forecasting has been close to zero. Idle cash has not mattered, and as a result, forecasting processes atrophied.

But rising rates change all that. U.S. treasurers are now upgrading their cash forecasting processes, which have historically consisted of limited spreadsheet calendaring functions. Companies are now building sophisticated and integrated methodologies and using tools in their treasury management systems. They are doing more granular analysis of historical cash flows to improve daily and weekly forecast precision, and more comprehensive statistical analyses of other business variables for intermediate and longer-term forecasts.

Updating Policies And Centralizing Control
U.S. treasurers are taking a hard look at their global treasury organizations. With empowered technology and updated treasury policies, many are able to centralize control and authority and standardize global processes, while maintaining decentralized operations. They are examining the proper structure of their regional treasury centers and many are setting up payment factories.

Along with this, treasurers are examining the size and skill set of their staffs. Many roles are becoming more technical and quantitative. Other roles require interface with both external and internal stakeholders.

Treasury Strategies
The Power of Experience®

Summary

The treasurer's role has never been so complex, regardless of where the company operates. In addition to macro factors impacting all firms, U.S. treasurers have some challenges unique to the U.S. economic and regulatory environment. This article has enumerated them and the ways our U.S. clients are responding to them.

Info@TreasuryStrategies.com

TreasuryStrategies.com

The Power of Experience®