White paper

Revisiting Liquidity Management

In an increasingly complex short-term investment environment, is it time to review your strategy?

Rising interest rates, game-changing regulations, and tax reform are giving a broad range of organizations reason to take a fresh look at their liquidity management practices and review their investment policies.

This paper reports on these key developments and what U.S. corporations and their offshore entities — as well as public agencies, foundations, and endowments — should consider as they re-evaluate short-term investment options in response.

CONSIDER THESE INVESTMENT OPTIONS TO MEET YOUR GOALS FOR SAFETY, LIQUIDITY, AND YIELD

- Overnight Deposits
- Time Deposits
- Money Market Deposit Accounts
- Prime Money Market Mutual Funds
- Government Money Market Mutual Funds
- Separately Managed Accounts
- Short Bond Funds
- Treasury Bills
- Tier-1 Commercial Paper
- 31-Day Call Deposits
- Hybrid Accounts

IMPACT OF INTEREST RATES

Following a seven-year, post-recession period during which the benchmark U.S. short-term interest rate was kept near zero, the Federal Reserve Bank (the "Fed") in December 2015 began a series of quarter-point rate increases. The Fed is projecting a continuation of modest hikes — at least three a year — through 2019.

This shift in the rate environment has treasurers once again thinking strategically about earning a return on cash.

Unlike from 2008 to 2015, when cash literally was earning next to nothing and there was very little difference between the returns on various investment products, treasurers now face meaningful decisions about where to invest cash to maximize yield and achieve desired exposure to different asset classes.

But the rising rate environment is just one of the developments giving treasurers a reason to focus more on liquidity management and re-evaluate a broader range of short-term investment alternatives.

POST MONEY MARKET REFORM

New regulations are also driving a renewed focus on short-term investments. Chief among these are rules introduced as part of the reform of money market mutual funds ("funds") dictated by the U.S. Securities and Exchange Commission (SEC) and fully implemented in October 2016.

Reform led many organizations to pull back from prime funds, a popular investment alternative that offered a yield advantage over government funds

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yet was still considered to provide a high degree of safety. With reform introducing liquidity gates and redemption fees for prime funds, as well as a requirement that they float their net asset value (NAV), such funds lost some of their conservative appeal. In fact, having preservation of principal and liquidity as key objectives, many investors either reduced their tactical allocations to prime funds or eliminated them as an approved option in their investment policies.

Since the initial, post-reform flight from prime funds, balances in those funds have been slowly rising, although organizations remain cautious. According to the 2017 AFP (Association for Financial Professionals) Liquidity Survey, while 41% of respondents no longer planned to invest in prime funds at all, 23% said they might invest in prime funds if the NAV doesn't fluctuate much, and 20% said they would consider investing in prime funds if the spread between prime funds and other investments becomes significant.[1]

Some investors have moved cash from prime to lower-yielding but safer government funds. But for others who are looking to segment their cash further due to rising rates and the reduced appeal of prime funds, the questions have been: What can I safely invest in today that will beat returns on government funds? And, how do I replace some or all of the yield I could have earned had I been able to stay invested in prime funds?

Some investors who abandoned prime funds are already asking themselves how large the spread will have to be between prime and government funds in order for them to consider moving some cash back into prime funds. But in the meantime, without this asset class as a clearly attractive investment option, many investors are looking for yield in other vehicles, including separately managed accounts and short bond funds. These assets offer yields similar to those of prime funds but without the liquidity gates and redemption fees.

Separately managed accounts allow an organization to control liquidity by requiring an investment manager to adhere to an investment policy. Also, with these accounts, liquidity can't be limited by the actions of others investing in the same vehicle, as would be the case in a commingled vehicle such as a prime fund.

Short bond funds are an off-the-shelf entry into a product that doesn't require hiring an investment manager. Although similar to a prime fund with a fluctuating NAV, they are not money market funds and tend to have higher risks because they are not subject to the strict investment requirements that govern money market funds.

Another strategy being considered in this environment is outright investment in commercial paper. With such a strategy, however, investors must determine whether the incremental returns will justify the time and expense related to using trading and credit analysis resources.

Results of the AFP survey suggest that, to the extent safety of principal continues to be a top priority, bank deposits should remain an attractive alternative to government funds. Explains AFP in its survey report: "Investing in safe, liquid products and getting credit for it on a bank scorecard are important to corporate treasurers — especially in an environment where they primarily manage department costs over managing yield. Picking up an extra 10 basis points in yield may not be worth it if principal is at risk."[2]

EFFECT OF BANK CAPITAL REGULATIONS

Decisions about investing in bank deposits are being impacted by another form of regulation — rules introduced to ensure adequate bank capital and stability following the financial downturn.

Some of the rules and guidelines coming out of Basel III, most notably the Liquidity Coverage Ratio (LCR), require financial institutions today to look at their deposit business differently. Banks used to be able to view all deposits as equal, but no more.

In the Basel III era, banks must maintain minimum levels of "high-quality liquid assets" to ensure against deposit runoff. What that means is there is now a hierarchy for banks when they evaluate any particular bank deposit. For instance, consumer deposits are considered higher quality and thus more valuable to banks than commercial deposits, and business operating accounts are more valuable than business non-operating accounts. What's more, your deposits may be more or less attractive to a bank depending on your industry (with financial institution deposits being among the least desirable).

As a result, treasurers who make short-term investment allocation decisions need to engage in more strategic discussions with their banks about their deposit options. In today's regulatory environment, some treasurers may need to spread their deposit business across a greater number of banks, or possibly consider other off-balance-sheet investment options. Larger banks often offer these in addition to on-balance-sheet deposit products.

Investors may also want to consider some of the newer deposit products that banks have introduced to address the new capital standards. Among these are 31-day call deposits and hybrid accounts that provide a combination of earnings credit to pay for bank services and interest on excess operating funds.

THE NEW TAX LAW

Changes to the tax code are expected to increase the focus on liquidity management as well, by boosting the amount of cash many organizations will have to invest.

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One way the Tax Cuts and Jobs Act of 2017 will do that is through its provisions about repatriating overseas cash. The law allows for a one-time repatriation rate on tax-deferred foreign earnings: 15.5% for liquid assets and 8% for illiquid assets, compared to the 35% corporations traditionally pay to repatriate such funds. Most estimates suggest prior to the law there was more than $2 trillion in accumulated untaxed U.S. corporate earnings sitting offshore. U.S. companies are not required to repatriate those funds, but since they will be taxed on them either way, many are expected to do so. In other words, a number of U.S. companies are seeing, or will soon see, an influx of repatriated cash.

Organizations are likely to use some of that repatriated cash for things like share buybacks, dividends, mergers and acquisitions, capital spending, debt repayment and employee bonuses. However, at least initially much of the cash will go into short-term vehicles.

Something to watch: How organizations choose to invest repatriated cash could impact market rates for various investment options. For example, if an outsized amount is invested in Treasury bills, that would increase the demand for T-bills and drive down rates on those instruments.

Tax reform is also expected to increase cash levels at many organizations by lowering the corporate tax rate from 35% to 21%.

WORKING CAPITAL IMPLICATIONS

Liquidity management is a key aspect of managing the working capital cycle for any treasury manager. In addition to monitoring cash flows, maximizing daily cash position, paying down debt and borrowing efficiently, liquidity management calls on treasurers to make sound decisions about short-term investment allocations.

Rising interest rates make these decisions even more significant. Other recent developments we've discussed here — new regulations and tax reform — also further complicate the challenge.

In a nutshell, these developments are generating more cash for U.S. organizations to manage while creating compelling reasons for their financial managers to re-examine allocation strategies.

According to the AFP survey, nearly three-quarters (72%) of organizations have a written investment policy that dictates their short-term investment strategies.[3] Policies typically stipulate permitted investment vehicles and the percentage of the portfolio that may be allocated to each one. For organizations that have an investment policy, with all the changes occurring in the short-term investment environment, now is a good time to revisit that policy. For organizations that don't have a policy, now is an ideal time to establish one.

If your organization has global interests, with any review of investment policy it's critical that you recalibrate investment strategy for offshore as well as U.S.-based accounts.

Finally, in this increasingly complex environment, where should you go for counsel? Who can help you review your strategies and policy? According to the AFP survey, 87% of finance professionals identify banks as resources their organizations use to access information about cash and short-term investment holdings. Other information sources include investment research from brokers/investment banks (43%), credit rating agencies (31%), money market portals (28%), and money market funds (25%).[4]

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[1] 2017 AFP Liquidity Survey (Report of Survey Highlights), p. 5. www.afponline.org/liquidity.

[2] 2017 AFP Liquidity Survey (Complete Results), p. 17. www.afponline.org/liquidity.

[3] 2017 AFP Liquidity Survey (Report of Survey Highlights), p. 3. www.afponline.org/liquidity.

[4] 2017 AFP Liquidity Survey (Complete Results), p. 14. www.afponline.org/liquidity.

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