



12 ways to reduce the pain of negative rates

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Niveau de difficulté élevé / Schwierigkeitsgrad hoch

Introduction and challenges

Negative interest rates in Swiss Franc (CHF) have created serious challenges for various market participants and their treasury desks:

- **commercial and private banks** with excess cash reserves are being charged a negative interest rate of 0.75% above a specific threshold on their deposit account with the Swiss National Bank
- **insurance companies** are facing strong headwinds in their life and annuity businesses
- unless they are fully invested, **pension funds** are eating into their capital on their cash reserve. And their 40-60% fixed income allocation represents an asymmetric risk-return payoff against them when yields reach zero: i) a normalization in rates would bring significant losses to the bond portfolio (risk) and ii) the upside potential in bond prices is virtually non-existent
- **commercial banks** with a volume of fixed payer swaps in excess of receiver swaps (hedging of their mortgage book) end up paying the negative Libor rate fixing on the top of the fixed rate. At current Libor fixings (let's say – 0.8%), this is equivalent to reducing the average margin they earn on fixed rate mortgages to zero
- **corporate treasurers** are confronted with similar issues as commercial banks, both on their corporate cash reserves and their existing interest rate hedges (mainly payer swaps).

The warrior mindset

“The basic difference between an ordinary man and a warrior is that a warrior takes everything as a challenge while an ordinary man takes everything as a blessing or a curse.” -- Carlos Castaneda

A close friend of mine, CEO of a low margin industrial business, puts it this way “We are not being paid to complain but to find solutions”.

Solutions to the pain of negative rates on CHF cash reserves

1. Spend your cash

- Organic growth: New projects, capital expenditures, R&D
- Dividend increase (beware that shareholders will count on it forever) or extraordinary dividend presented as such
- Share buy-backs: beware the fact that they are irreversible, beware the timing (avoid buy high = at market tops and sell low = in crisis times). For an excellent discussion on merits and risks: <http://economyandmarkets.com/markets/investing/stock-buybacks-better-in-theory-than-practice/>
- Mergers & Acquisitions
- One-time contribution to corporate pension fund to improve its coverage ratio.

2. Pay back your debt (and reduce your balance sheet size)

Avoid paying a spread on your bank loan (in most cases it will be floored at zero) and at the same time suffer from a negative yield on your cash deposit.

3. Enhanced liquidity planning

Paying a negative interest margin of 1% running is acceptable (cash deposits at zero, Libor + spread debt at 1%). When cash deposits suddenly cost 0.75%, it is worth monitoring the liquidity situation more closely and considering a reduction in the overall amount of liquidity (not the operational but the reserve and strategic liquidity). Also, every new term financing will be analyzed under

- a) its merits: cost effectiveness, reduction of both refinancing and interest rate risk, as well as
- b) its consequences on the liquidity position now and in the foreseeable future.

A reduction of 0.25% in the cost of new term debt only makes sense if the excess cash is not penalized at – 0.75% for prolonged periods of time.

With the ECB in full QE mood, no one knows how long and how low negative interest rates will be.

4. Working capital management upside down

In times of credit crunch with a very limited and costly access to liquidity, corporates do their best to reduce the average number of days on their account receivables and negotiate a time extension on their account payables.

When short-term deposit rates are negative and liquidity is abundant, corporates should focus their attention on obtaining a discount from their suppliers if they pay their invoices within a few days. The discount represents a positive yield on their corporate cash. Extraordinary situations require new and flexible solutions. What made sense one year ago may no longer be the smartest thing to do. But don't forget the best practices of working capital management because you may need them again next year.

5. Extend the duration of your deposits

Move from sight deposits to i) 30 days plus term deposits or ii) rolling/rollover deposits (you have access to your cash after a pre-determined notice period: 1/3 after one month, 2/3 after 3 months, etc.)

What helps your bank reach its own liquidity target ratios will help to reduce your negative interest deposit rate.

6. From liquidity management to asset management

CHF money market funds are facing the same headwinds as your deposits. They operate in the same market environment.

If you are a large corporate sitting on a billion plus in corporate cash, you may consider managing it like a small pension fund: define an asset allocation that will balance the risks. Learn from the best asset managers, like hedge fund manager Ray Dalio and his “All Weather portfolio”. That's as good as it gets in terms of capital protection. The historical performance 1984-2013 (check the link below for the source; please note that this portfolio is for USD and not CHF as reference currency) is as follows:

- 9.72% average annualized return (net of fees)
- 26/30 positive years; 4/30 negative years with an average loss of just 1.9%
- worst year – 3.93% in 2008 (for comparison, the S&P was down 37%)
- Standard deviation of 7.63%.

<http://yahoofinance.tumblr.com/post/102956492899/tony-robbins-ray-dalios-all-weather-portfolio>

When you change the investment philosophy and relax some of your guidelines, make sure you have it properly approved (Board of Directors) and documented (what are the new guidelines: asset allocation, periodical rebalancing, liquidity considerations, etc.). Corporates can then implement their asset allocation via ETFs for both liquidity and cost effectiveness considerations.

7. Hmmm... Invest your cash in other currencies

Investing your CHF reserves in other currencies with a higher yield or entering into double currency deposits is a recipe for disaster. Increasing the risks (FX, credit spread) to escape low returns has cost more corporate treasurer jobs than any other mistake or misbehavior.

Bonus: The end of “cash is king” ?

Not quite. Having its capital at risk because of negative interest rates is no good news. But “cash is queen”: it remains the most flexible and therefore the most valuable piece on the chessboard.

Solutions to the pain of negative Libor rates in hedging instruments (CHF payer swaps)

Building blocks for our solutions (or opportunities)

- currency basis between USD and CHF is at historically very low levels (e.g. 5 years at – 0.4%)
- swap rates, which represent the average of the current (negative) Libor rates and the expected Libor in future (=Libor forwards) are in the negative territory until a duration of 3 years (as of early June 2015). In other words, new payer swaps are taking the negative Libor rates into account, which is not the case for payer swaps dealt before Q4 2014 and the introduction of negative interest rates by the Swiss National Bank
- combination of payer and receiver swaps to neutralize part of the adverse effects.

1. Negotiate with your bank (gentleman agreement)

Extraordinary situations require extraordinary discussions. It is my assumption that most business partners will continue to work together in future. Each counterpart can assess what the « black swan » event means for them and for the other party. When one side wins and the other loses, there is room for sharing part of the burden. When both sides are losers (e.g. bank treasury finances a corporate loan with savings accounts floored at zero and can therefore not accept to pass on a negative Libor to its corporate customer; the corporate customer ends up paying both legs of his interest rate hedge instrument), the negotiation will be tougher. It takes wise negotiators who can take short-term pain for the benefit of keeping the long-term relationship intact.

When the internal legal department and/or external lawyers are taking over the negotiations, treasurers need to make sure that the long-term partnership and common interests are not removed from the (short-term) equation. In the end, top management will have to weigh the pros and cons of a negotiated solution.

2. Let a judge decide for you

If and when a borrower and a lender have done business in the past but have ended their relationship, chances are higher that lawyers will take over from treasury managers. Each side will have a list of arguments and court cases will provide lawyers with an opportunity to position themselves as the “person-to-go-to” for litigations around loans and financial derivatives. This is a costly and lengthy process but some of the conflicts will end up being arbitrated by judges.

The more aggressively a corporate treasurer has been marketed by his bank to switch from fixed rate bank loans to a “floating rate loan + payer swap” model, the better his chances to see the bank sharing part of the burden of negative Libor fixings. The outcome also depends on the content of the bank term sheet, presentations and the presence or absence of proper disclaimers around risks associated with negative Libor rates.

Two remarks:

- Don't forget to consider the signals that your behavior and decisions will send to your old, current and future bank and lending partners. You may lose or disappoint them
- Beware loan contracts where banks have exit clauses after 6 months (they don't have to renew the loan and can exit the relationship). One bank may end up paying you a negative interest rate if you insist and threaten to go to court but they will only do it for 6 months and then they won't renew the loan. So you will have to find new banks/new financing.

3. Let the market help you (USD funding arbitrage)

This solution can help sophisticated corporate, insurance and bank treasuries to:

- create CHF debt not subject to a floor at zero and even
- reduce the burden by ca. 0.4% per annum (negative cross currency basis USDCHF).

But to qualify you need to have access to USD financing.

Let's take the example of a large corporate with business activities abroad to illustrate the mechanism: Rather than financing its Swiss activities by drawing on its multi-currency syndicated loan (or bilateral bank loan) in CHF where the Libor is floored at zero, the corporate draws its financing in USD and it enters into USDCHF cross currency swap. Result: on an after-swap basis, the corporate has created a synthetic CHF Libor financing which is not subject to a floor at zero.

This should work if

- i) you are dealing with large Swiss or foreign banks who are active in financial derivatives (but it won't work with a cantonal bank as lender)
- ii) you have ISDA or Swiss OTC master agreements in place with your banks

iii) you target a maturity up to 5 years. There are issues around swap line limits above 5 years, unless you have credit support annexes (or CSAs) in place.

Concrete example for a duration of 3 years (period June 2015 - June 2018). Financing alternatives:

- a) syndicated loan in **CHF**, corporate finances at $\text{Libor} + 0.5\%$. Libor floored at zero means corporate pays 0.5% (*loan spread*) + swap fixed rate (we assume 1%) + 0.8% (negative Libor fixing of -0.8%) = $0.5\% + 1.0\% - (-0.8\%) = 2.3\%$ **initial debt cost**
- b) syndicated loan in **USD**, i) corporate can finance at $\$3\text{M Libor} + 0.5\%$ (same spread above Libor) and ii) corporate enters into a cross currency swap USDCHF and after swap pays $3\text{M CHF Libor} + 0.1\%$, assuming a cross currency basis at -0.4% and ignoring swap costs. With 3M CHF Libor fixing at -0.8% this represents an initial cost of 0.7% . And $0.7\% + 1.0\% - (-0.8\%) = 1.1\%$ **initial debt cost**.

The lower the (negative) CHF Libor fixings, the larger the advantage of financing in USD and swapping into CHF compared to CHF financing.

If CHF Libor fixes at zero or in positive territory, the advantage of financing in USD disappears.

PS: We won't go into the details of hedge accounting and/or P&L volatility implications, but make sure you speak to your accounting expert and/or external auditor. And monitor your counterparty risk limits. One last warning: if you are worried about the introduction of negative Libor rates in USD, you should buy a floor against 3M USD Libor with a strike at zero. Unlike in CHF, this floor is liquid and cheap.

4. Learn from politicians: Kick-the-can (forward starting swaps)

In short: Transform existing Fixed Payer swaps into Forward Starting Swaps

In order to avoid paying on both legs of an existing payer swap with a positive fixed rate, corporate and bank agree to stop the cash flows (fixed and float legs) for a period of 2 years (=expected duration of negative interest rates). The existing swap is "postponed by 2 years" but its tenor will stay the same.

If you can't agree or negotiate with your bank to leave the fixed rate unchanged, the fixed rate is reset slightly higher or the swap tenor is extended.

This is an ideal solution in the current low interest rate/flat yield curve environment.

Concrete example: existing payer swap covers the period 2013-2020 and has a residual maturity of 5 years in 2015. It is transformed into a 2y-into-5y payer swap. Post amendment, swap still has a 5 year tenor but it now covers the period 2017-2022.

There will be no exchange of cash flows during the next 2 years, no negative carry from the swap, corporate pays $\text{Libor} + \text{spread}$.

PS: same as point 3. above.

5. Learn from the Jedi: the sword has two edges (receiver swaps)

In short: neutralize your Libor exposure by balancing fixed payer with fixed receiver swaps (Libor will offset).

If a **bank** finances corporate and mortgage loans with savings which are floored at zero, it is still possible

for the bank to find other sources of financing which are Libor based and not subject to a floor at zero.

- i) raise USD financing and swapping into CHF is a solution (see point 3. above), or
- ii) issue a fixed rate public bond and swap it into floating or
- iii) raise financing via the Pfrandbriefzentrale and swap it into floating

In ii) and iii) the bank will receive the prevailing (fixed) swap rate and pay Libor (not floored).

In order to avoid going to court with their banks, **corporate** treasuries with existing payer swaps on which they pay both legs in addition to their floating rate loans (Libor floored at zero + spread) can negotiate the following deal with their bank:

Concrete example: existing payer swap covers the period 2013-2020 and has a residual maturity of 5 year in 2015.

Corporate enters into a 5 year (fixed) receiver swap mirroring the existing payer swap for the remaining period 2015-2020 (same notional amount). The corporate will then crystalize a negative annuity (=different between the fixed rate of the old payer swap and the fixed rate of the new receiver swap). But the point is that the corporate can negotiate with its bank the fixed rate of the new receiver swap.

This solution will also guarantee that the corporate will not suffer more (pain of negative carry) in case the SNB decided to cut rates even lower into negative territory.

PS: same as point 3. above.

Bonus: How to keep the North in an upside down world: think in terms of carry

To end this article on a lighter note: in a world of negative interest rates, when trading a short-term payer swap you end up receiving the fixed leg (as you pay a negative fixed rate) and paying the floating leg (as you pay the negative Libor fixing).

To avoid the confusion associated with this new environment, I avoid thinking in terms of “ah, so a fixed payer swap is now a receiver swap” because what may be true for 3 years may not be true for 10 years, what may be true for a spread of 0 basis point may not be true for a spread of 1%.

Rather think in terms of the shape of the yield curve and initial carry: a fixed payer swap means you are paying further out on the (upward sloping) yield curve and you receive the short end (Libor). Since the introduction of negative interest rates by the SNB, the yield curve has experienced a parallel shift down. In terms of initial carry, a payer swap still has a negative carry (as it was the case before) because the 3 year swap rate is higher than the first Libor fixing. As market participants do not expect negative Libor rates to stay for longer than 2018 (based on CHF yield curve as of early June 2015), the shape of the yield curve will likely remain unchanged so you’ll keep your North when reasoning in terms of carry.

HypoPilotely Yours,

M i c h a e l & R o b e r t

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