To Brexit or not to Brexit: So what is next?

Finance- and Treasury Management Switzerland

Imagine the following scenarios: An exchange rate loss of 5-10% for the British pound, several interest rate hikes by the Bank of England, a change in the reporting process for derivatives, an abrupt change in the core banking strategy, and more. All these scenarios may turn into reality since the UK's withdrawal from the European Union has been anything but smooth. Particularly recent negotiations have been fraught with uncertainty.

Even the very day the Brexit was supposed to happen, it was still completely unclear whether, how and when Brexit will be implemented and what the specific consequences will be. There are two possible scenarios: either a hard Brexit or a possible extension of the deadline with the hope of clearing up all outstanding issues between the EU and the UK.
So what does Brexit mean for treasurers in particular? What are the implications on the way treasurers do business? How will business relationships be affected?

While far from easy questions, they certainly touch upon some of the issues that treasurers need to consider in order to be prepared for the future. This article would like to discuss some of the issues relevant to your treasury.

Questions in regard to financing

Financing is one of Treasury's core functions. Due to its complexity, financing also has an impact on many other treasury areas, such as cash and liquidity management, foreign exchange and interest rate management or bank relationship management. Financing is often used to meet liquidity needs and is provided by banks or capital markets. Both would be severely affected by a no-deal Brexit. This could put treasurers in an undesirable situation where they have a liquidity deficit that cannot be covered. And since we have often seen profitable companies go bankrupt due to liquidity problems, avoiding this situation should be paramount for all treasurers. The following questions can help avoid this situation:

- How will a no-deal Brexit affect the overall financing strategy? Should my company change its capital structure (debt vs. equity)?
- Have we performed scenario and gap analyses and benchmarked relevant interest rates and exchange rates to assess their impact on cash flow in case of a change in financing costs due to revaluation and changed spreads?
- Should we expect there to be less scope for credit lines and/or covenant criteria? How likely is it that credit lines will be canceled?

- Have alternative financing sources been considered in the context of a possible credit crunch in the UK?

Although it is impossible to answer these questions comprehensively, the following points should nevertheless be considered when searching for a solution:

- Structure of the credit portfolio
    1. What are the percentages of medium and long-term liabilities?
    2. Are there any binding and written liabilities?
    3. In which base currency are our loans written?
- The current low interest rates may change, hence affecting financing costs. This must be closely monitored with a thorough sensitivity analysis to verify the impact on cash flows.
- In order to avoid covenant breaches, it is imperative to closely monitor all covenant criteria and execute multiple scenario analyses.

The company's capital structure in terms of debt, equity and credit portfolios and underlying currencies must be analyzed appropriately. For instance, a situation could arise where the Bank of England and the European Central Bank take two opposing approaches on interest rates, which could then have a significant shock on liquidity, interest expenses and credit prices.
In addition to evaluating the company's financing and its sources, there should also be a thorough assessment of the normal external providers of financing: the banks. This leads us to Bank Relationship Management.

Questions regarding Bank Relationship Management

The Brexit will affect banks in a very similar way to companies, which means that banks may also have to change their strategic direction and risk appetite. In such a situation, they tend to re-evaluate their current customer base, much like treasurers could re-evaluate their banks.

In this situation, treasurers may want to ask the following questions:

- What could a change in corporate strategy mean for our existing banking relationships?
- Will banks continue to meet the investment criteria even after there has been a change in credit rating?
- How will changes in banking strategy and banks' risk appetite affect us?
- What is the impact of Brexit on the banking sector in the UK in general?

Changing perspective, the following questions (which our company cannot affect) should also be considered:

- What happens if a bank decides to withdraw from certain countries?
- And what happens if a bank changes its risk appetite and decides to focus only on a few core industries and customers?

For treasurers, this may mean unwanted changes in business activities and have implications on the company's core banking strategy.

Treasurers can try to counteract legal uncertainty and ambiguity by shifting business from UK banks to continental banks. Before doing that, however, there are specific points that treasurers should consider first:

- Possible changes in bank partners and revisions of the approved bank list
- Communications with relationship managers for early warning on when a bank might withdraw from a particular business area
- Elaboration of a strategy on how to address the segregation of banking within and outside the EU and within the Euro zone
- Monitoring of banks' credit ratings, as a change in the credit rating could mean that current investment criteria are no longer met

And last but not least, transferring existing derivative transactions from the UK to continental banks could have undesirable accounting effects. According to IFRS 9, a change of bank means a significant change in business parameters and thus the derecognition of the previous transaction and the recognition of a new transaction. For this reason, the existing hedge accounting would have to be terminated and a new hedging relationship designated. This can only be avoided by relocating to a branch of a UK bank that has the same credit risk as the London based headquarter.

Questions regarding counterparty risk

Just as banks evaluate their customer base and risk appetite, companies and treasurers must also evaluate their counterparty risk. This is because a changing economic environment may affect creditworthiness. Some investments previously considered attractive will now become riskier and may no longer meet the company's risk policy. The main questions that need to be asked here are therefore:

- How will counterparties' risk profiles change if their credit ratings change?
- Are there any scenarios addressing a potential change in hedging costs?

Treasurers can counteract this in several ways. When assessing the approach, the following aspects should be taken into account:

- Is additional collateral from counterparties required?
- Monitoring the impact of credit rating changes on subsidiaries

Questions on derivatives and regulatory requirements

Brexit will also lead to changes in the regulatory environment, such as in the reporting process for derivatives. The European commercial register Regis-TR has already announced the introduction of a new UK commercial register, which will also serve British companies.
As of today, it is expected that a separate UK register will exist as of 1 April 2019. For self-reporting entities, however, this initially only means that the counterparty must be stated as "non-EU" so that the register does not attempt a reconciliation.

The following must therefore be observed:

- As of 1 April 2019, it is likely that UK companies will no longer have to report their derivatives to Regis-TR under EMIR, but rather to a trade repository recognized by the UK supervisory authorities under UK law.
- Regis-TR has created a separate Trade Repository for this purpose.
- The reporting is expected to be very similar, but not identical.
- On-behalf reporting is possible, but must be made to the UK-TR – a cross-reference to EU-TR is not possible.

For many hedging instruments, the main question should therefore be:

- Which instruments should be used to hedge expected currency/interest rate fluctuations? Options or forwards?

Many companies use forwards because they do not require premium payments. Options, on the other hand, are a good way to protect against downturns, but given their higher volatility, the cost could be significant. One strategy could be to identify the worst exchange rate your company is willing to accept and then set the strike price accordingly.

Questions for Cash Managers

Cash managers need to examine the impact of Brexit on their business. As many companies have cross-border activities, this is where international cash management comes in. One of the main questions cash managers need to ask themselves in this context is:

- How will Brexit affect my overall cash management strategy?

When answering this question the following should be considered:

- Advantages versus disadvantages of different types of cash pools (for example, notional pools vs. zero-balance agreements).

- In times of uncertainty, there is usually a tendency to accumulate more liquidity, for example to reduce counterparty risk, to have the operational flexibility needed, or to create buffers for unplanned crises or acquisition opportunities. Treasurers must consider the ramifications of excess cash until conditions return to normal.

So what is next?

Whether a hard Brexit or a postponement will follow, you should be prepared. Ideally, you should have started and maybe already completed preparations for the possible scenarios, including a "Brexit without a withdrawal agreement"? Are you ready to face a no-deal Brexit scenario? One thing that is clear is that the Brexit will not end on 29 March. You should be prepared for a long and complex process.

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Euro-zone interest rate policy:

Will interest rates keep on falling or become a trap?

Finance- and Treasury Management Switzerland

Treasurers have been struggling with negative interest rates in the euro zone for 4 years now. Especially short-term liquidity is no longer an attractive money market investment. Since 2016, the markets have repeatedly promised to raise interest rates, but so far, this has not materialized. The ECB recently dispelled the hope for a turnaround in interest rates in 2019, instead postponing it to 2020 at the earliest.[1]

Moreover, these days, the IMF is tossing about the idea of decoupling electronic money from cash, and familiar buzzwords such as helicopter money are making the rounds. The signs therefore point more towards a worsening of the interest rate situation than towards a return to normal interest rates in the near future. In this article, we would like to shed some light on the background to this development and the potential implications for Treasury.

The current situation of the interest rate and currency system

Since 2014, interest rates in the euro zone have been close to zero or even negative. Originally, the reason given by the ECB for the interest rate cut was to boost the economy and to encourage loans. The economy has improved consistently since the end of the financial crisis (also due to a favorable global economic situation) with peak levels reached in equities, real estate and other investments. Since the end of 2018, however, the global economic outlook has become somewhat gloomier.

This is partly due to the trade and customs disputes between the USA and China, as well as the USA and Europe. Last but not least, Brexit has also become a major uncertainty factor for the markets and investors. For example, incoming orders from the manufacturing sector, which has shown a downward trend[2] since the end of 2017, underscore this bleak outlook. The driving force of the German economy, the automotive industry, has also recently reduced its sales forecasts and the industry is facing a critical year.[3] A stagnating or weaker economy is not the moment for a significant interest rate hike. As already mentioned in the introduction, the ECB seems instead to be trying to consider other measures to stabilize and revive the economy.

In a normal, positive interest rate environment, the central bank would lower interest rates even further, but this has become nearly impossible with interest rates already at zero or even negative. In

[1] https://www.tagesspiegel.de/wirtschaft/ezb-ratssitzung-mario-draghi-wird-als-nullzins-praesident-in-die-geschichte-eingehen/24078568.html
[2] https://www.destatis.de/DE/PresseService/Presse/Pressemitteilungen/2019/02/PD19_042_421.html
[3] Zeit Artikel: https://www.zeit.de/news/2019-03/03/vw-chef-sieht-deutsche-autoindustrie-vor-kritischem-jahr-190303-99-218712

July 2012, the head of the ECB, Mario Draghi, promised to do everything (at least within the ECB's mandate) to save the euro. It is in this context that we should assess the measures to stimulate economic demand currently under discussion. In addition to the option of helicopter money (i.e. the direct injection of central bank money into an economy), the IMF's idea to lower interest rates to well below zero is being discussed among experts[4]. The IMF economists Agarwal and Krogstrup lead the way:

"Many central banks have lowered key interest rates to zero during the global financial crisis to boost growth. Ten years later, interest rates remain low in most countries and while the global economy has recovered, future downturns are inevitable. In previous severe recessions, a three to six percentage point cut in key interest rates was required..."

This would mean a key interest rate of between minus three and minus six percent for the euro zone. Such a drastic negative interest rate on bank deposits would make cash holdings attractive and thus lead to a massive withdrawal of deposits. To prevent this, economists propose separating cash and bank deposits into two different currencies, which would make the holding of cash at least as unattractive as holding bank deposits. This would require an exchange rate between bank deposits and cash. If the bank money now bears a negative interest rate, the exchange rate from cash to bank money is devalued annually by the same ratio. The working paper by Signe Krogstrup and Katrin Assenmacher, "Decoupling Cash from Electronic Money"[5] (in her role as the Head of the ECB's Department for Strategic Monetary Policy) shows that the ECB is not disinclined to entertain such ideas either.

What are the repercussions and risks for the monetary system resulting from the special interest rate situation and a possible further reduction in key interest rates?

In the euro zone, the primary focus should be on commercial banks. Commercial banks are an essential cornerstone of the monetary system, as they are largely responsible for creating bank money through lending. In contrast, the share of central bank money in the overall money supply is only about 10-15%. However, this money and lending system is calibrated to a world with positive interest rates; the prevailing low-interest environment is increasingly exacerbating the banks' situation in terms of their profitability and risk-bearing capacity.

Continuously declining profitability of banks

In its report on banks' earnings situation, the German Central Bank (Deutsche Bundesbank) states:

"...The low level of interest rates caused by the expansionary monetary policy measures and the flat yield curve, as well as the negative interest rate on banks' surplus deposits with Eurosystem, which has been at -0.4% since 16 March 2016, in themselves reduced the net interest income of the banks... Major banks, the Landesbanken as well as mortgage banks have again reported a noticeable decline in net interest income despite shrinking balance sheet totals. As this drop could not be offset by other net income from operating activities, operating income in these banking groups fell markedly...".[6]

In addition to commission income, a bank generates 70 - 80% of its income from interest margins. The loan margin, as an essential part of a bank's income, is being eroded due to the current interest rate situation on the one hand and the increased supply of loans on the other, with demand for loans not growing at the same rate. (On average, the margin for corporate loans in mid-2018 was 1.41%, the lowest level since the financial crisis of 2009)[7]. The average duration of loans has continued to grow steadily in recent years, as customers have secured favorable conditions for themselves over the long term. As a result, banks' loan books are filling up with long-term, low-margin business. The long duration means that banks have to commit themselves to "unfavorable conditions" for a correspondingly long term, thus taking longer to remove these unfavorable loans from the books.

[4] https://blogs.imf.org/2019/02/05/cashing-in-how-to-make-negative-interest-rates-work/
[5] Monetary Policy with Negative Interest Rates: Decoupling Cash from Electronic Money
[6]https://www.bundesbank.de/resource/blob/759806/73b1edc6d411dd1db2c079d26fb9c249/mL/2018-09-ertragslage-data.pdf
[7] https://www.handelsblatt.com/finanzen/banken-versicherungen/firmenkredite-der-unheimliche-schuldenboom-der-deutschen-banken-beunruhigt-die-aufseher/23189882.html

In 2018, demand for loans rose at an above-average rate compared with previous years.[8] However, at least according to the experts at KfW Kreditanstalt, the reasons have less to do with an investment boom than with a potentially slackening economy and heightened uncertainty. Hence, companies could accumulate a financial cushion at low interest rates.[9] According to the Bundesbank, the only uptick in the earnings was achieved through fees and the commission business. Net commission income includes, in particular, fees from checking and payment transactions, securities and custody business as well as remunerations for brokering activities in connection with credit, savings, home savings and insurance contracts. In view of limited growth rates, customers' price sensitivity and increasing competition in the payment and financing environment from innovative FinTechs, it is unclear how long banks will be able to rely on this segment.

The declining quality of banks' credit portfolios

It should also be noted that the combination of the ECB's quantitative easing, low interest rates and intensified competition among banks has led to increasingly lenient lending conditions for corporate and housing loans over the past few years, as confirmed by relevant reports by the ECB and the German Bundesbank.[10]

Another aspect that should also be examined is to what degree banks' internal rating models (originally designed positive interest rates in mind) still reflect the actual creditworthiness and solvency of potential borrowers (e.g. indicators on the likelihood of interest payment and principal repayment capacity, overall profitability or debt repayment ratio), or whether these are not too optimistic. Ultimately, there is a risk that adverse selection will take place because of too favorable credit conditions, i.e. the demand for credit from customers with high creditworthiness and stable equity remains constant or even decreases, while the demand for credit from customers with poor creditworthiness increases. This scenario is confirmed, among other things, by the fact that the number of corporate insolvencies has almost halved between 2006 and 2018 and that the average insolvency ratio is below the long-term average in a normal interest rate environment.[11] However, Euler Hermes expects the number of corporate insolvencies to increase by 6% in 2019 due to the weak economic outlook and the corresponding reduction in corporate profitability.[12]

What does this mean for banks, the corporate sector and the monetary system as a whole?

The shrinking margins are becoming increasingly apparent in the banks' income statements. As described above, margins have already disappeared completely or the old high-margin lending business is gradually being replaced by new low-margin business. Conversely, if the current situation in the interest rate market persists, this means that margins will shrink even faster. On the other hand, banks have so far had a rather rigid cost structure, which at some point may mean that income no longer covers costs. The consequence is the reduction of banks' equity base, thus lowering their risk-bearing capacity and ultimately their ability to grant loans. Reduced lending means a shrinking money supply and deflation for capital and consumer goods - exactly the scenario the ECB wants to prevent.

If the central bank's solution is to raise interest rates, the question concerning the credit portfolio is about the quality of the loans and how robust the borrowers' cash flow is, i.e. whether they are capable of repaying these. The fact that, assuming unchanged low interest rates and a sluggish economy, leading credit insurers believe that corporate bankruptcies will increase by 6%, suggests that the portfolios are somewhat sensitive in this regard. If, on top of this, one considers the fact that overall economic default rates have fallen continuously since 2009 (from 2.17% to 1.44%)[13], it may be assumed that over the past 8-10 years, there has been an accumulation of companies that might have had to file for insolvency under normal market conditions. At this point, we can only speculate about the numbers of affected companies and households. What remains questionable is the prosperity of these companies and their ability to make repayments if interest rates were to rise. In the event of a critical mass of non-performing loans, which in extreme cases would have to be written off, this

[8] https://de.statista.com/statistik/daten/studie/6798/umfrage/kredite-an-unternehmen-und-selbstaendige/
[9] https://www.handelsblatt.com/finanzen/banken-versicherungen/kfw-kreditmarktausblick-das-kreditgeschaeft-boomt-doch-die-gruende-sind-unerfreulich/23140420.html?ticket=ST-1259745-JCv0uHMHxwfsp5docB6l-ap1
[10].https://www.bundesbank.de/resource/blob/764574/523ab4f9da55154befcdd8cbb7ac0b0b/mL/2018-10-23-kreditgeschaeft-download.pdf
[11] https://de.statista.com/statistik/daten/studie/75215/umfrage/unternehmensinsolvenzen-in-deutschland-seit-2000/
[12] https://www.eulerhermes.de/content/dam/onemarketing/euh/eulerhermes_de/dokumente/euler-hermes-globaler-insolvenzausblick-2019.pdf
[13] https://www.creditreform-rating.de/pub/media/global/page_document/Ausfallraten_deutsche_Wirtschaft_2018.pdf

becomes relevant for the banks. This would also lead to a reduction in equity capital, lower risk-bearing capacity, a credit crunch as well as a smaller money supply with an ensuing lower demand.

It thus seems that neither an interest rate hike nor a further interest rate cut can offer a solution to the current situation. The IMF's proposed solution of introducing even more drastic negative interest rates would further accelerate banks' already eroding margins and, as a last resort, the ECB or the European governments would have to intervene in a similar fashion as they did in 2008/2009.

How significant and relevant is all of this for corporate treasury departments?

Treasurers should therefore probably expect interest rates in the euro zone to remain at the same level for the time being. Instead, the effects of negative interest rates and ECB policy should be analyzed and managed in view of one's own business model.

The search for profitable investment alternatives for excess liquidity

Once the operational business options to reduce possible excess liquidity are exhausted (e.g. by settling supplier invoices early), negative interest rates should be avoided in particular (or at least limited) for short to medium-term investments. For example in the case of classic money market instruments, time deposits with longer maturity periods can (still) provide a remedy to this quandary. In addition, there are alternative forms of investment such as credit-linked notes, where interest is charged based on the debtor's solvency and creditworthiness.

FX term deposits can also be used to generate higher interest income, where the domestic currency is turned into the investment currency with a higher interest rate level for the term of the investment with a swap. Nevertheless, this last alternative must take into account possible effects due to the exchange rate at maturity in the investment currency.

Possible actions in the event of major frictions on the interest rate market and the ECB intensifying its intervention policy

Should the scenarios described above materialize, i.e. interest rates falling significantly below zero or the commercial banking sector becoming more unstable, the following aspects will also require greater attention:

- **Internal netting for in-house banks and cash pools:** One advantage of an in-house bank for large corporations is that they can refinance themselves within the group at preferential interest rates and reduce their dependence on external financial institutions and thus lowering external costs. At the same time, excess liquidity can be invested at market conditions in a normal interest rate environment. By definition, an in-house bank is an intermediary that operates as risk-free as possible and should pass on any profits and costs to the corporation.

  In the age of negative interest rates, however, this also means passing on these external market conditions to the corporation, which could lead to conflicts between the in-house bank and the company and, ultimately, acceptance difficulties. Conversely, not passing on the external costs would inevitably lead to an accumulation of costs and risks within the in-house bank. This raises the question of how the bank is supposed to deal with these costs and risks and how intercompany interest rates and possible risk premiums and discounts (that are not in line with the market) are calculated and properly reported.

- **Liquidity reserves and hedging:** The advantages of a strong cash reserve or a refinancing source independent of the commercial banks became apparent at the latest, namely with the 2008 financial crisis and the collapse of Lehman Brothers. The global lending business almost came to a standstill at that time and even banks did not lend money to each other. The result was a lack of liquidity and a credit crunch, which had a very negative impact on investments and orders placed by companies and the private sector. Large corporations in particular often dispose of their own banking companies. These banking companies not only offer an independent refinancing basis thanks to their deposit base, they are also generally closely intertwined with the parent company's value chain and safeguard the value creation process at various levels.

Companies that do not have the critical size to set up their own bank should make their own supply chain with associated suppliers as transparent as possible and ensure the local financial security along this chain. A significant strategic advantage may also be that a variable cost structure and a low overhead can soften the potential blow of lower sales and liquidity constraints.

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