In light of today's possible rate cut, this report discusses how a bank rate cut and capital ratio pressure could precipitate negative corporate deposit interest rates in Canada.

It is a well-known fact that corporate deposits worldwide have reached unprecedented levels. Canada is no exception! According to a recent Huffington post report, corporate Canada's cash hoard hit $630-billion in 2014 and is likely growing. (Tencer, 2014) The Financial Times, in a recent report describes the severity corporate cash hoards impact on the US economy as being infested with "Zombie corporate cash". (Tett, 2015)

As for corporate Canada's probable response in the event of a negative rate scenario, adapting could result in a variety of tactics. For example, increased dividends such as [Vivendi in France.] According to AFPonline.org, "There are various factors that drive changes in overall cash balances. But the one having the greatest impact is operating cash flow. Similar to results in past surveys, most organizations that increased their cash holdings during the past 12 months did so because they were generating higher operating cash flow (cited by 72 percent of respondents). The second most commonly cited driver of greater cash holdings is generating additional revenues from the acquisition of a new company (25 percent) followed by a shortened/decreased working capital cash conversion cycle (21 percent)."

Attitudes of treasury managers support the view that corporates would accept negative rates. This conclusion is based on treasury department survey results that show 63% value security, 31% liquidity, and only 4% make decisions based on yield. Which is why high corporate deposits may be the new normal. (Advisors, 2015)

Evidence of the impact of cash hoarding are indicated by steady deposit growth in Canada, as shown in chart 1.

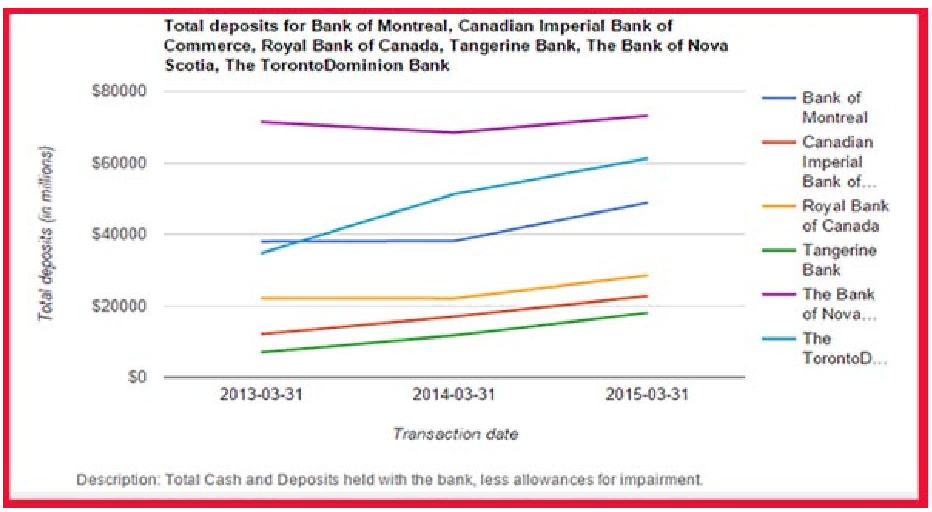

Chart 1, large bank deposit growth

Canada has followed US and European trends, having continued to grow their deposit base. Considering the fact that the interest paid on these funds in Canada is typically zero or near-zero, and that banks have strong balance capital rations and balance sheets contusive to lending growth, this has meant banks have experienced a bonanza of opportunity. Chart 3, for example, illustrates a strong and steady net interest margin (NIM). As you would expect, increasing loan portfolios and low cost deposits has resulted in a perfect storm that has led to increased share prices and profitability.

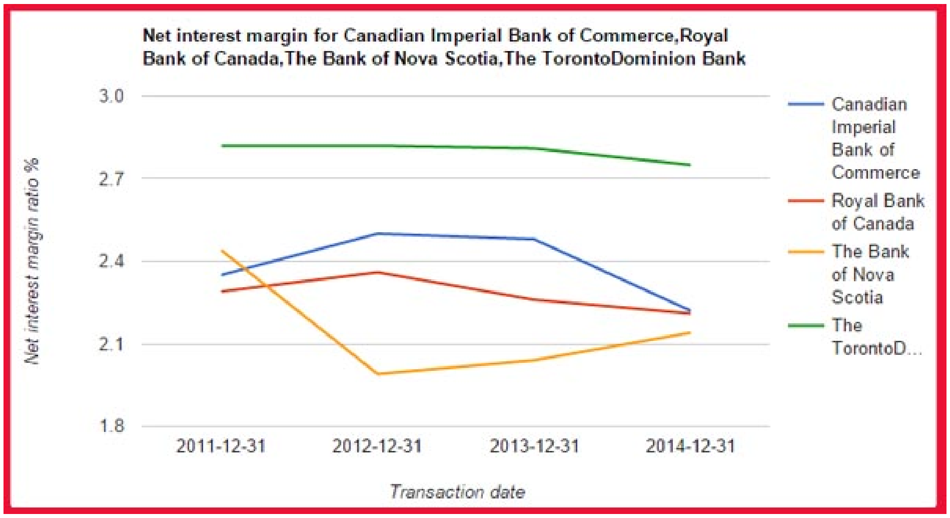

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Chart 3, net interest margin

The term "perfect storm" describes an event where a rare combination of circumstances aggravate a situation drastically. The problem for Canadian corporations occurs if bank share prices dip and/or risk increases, such that lenders fail to meet regulatory capital requirements. This could limit lending and lead to excess deposits, as has been the case particularly in Europe. This is currently not the case in Canada as chart 4 shows.

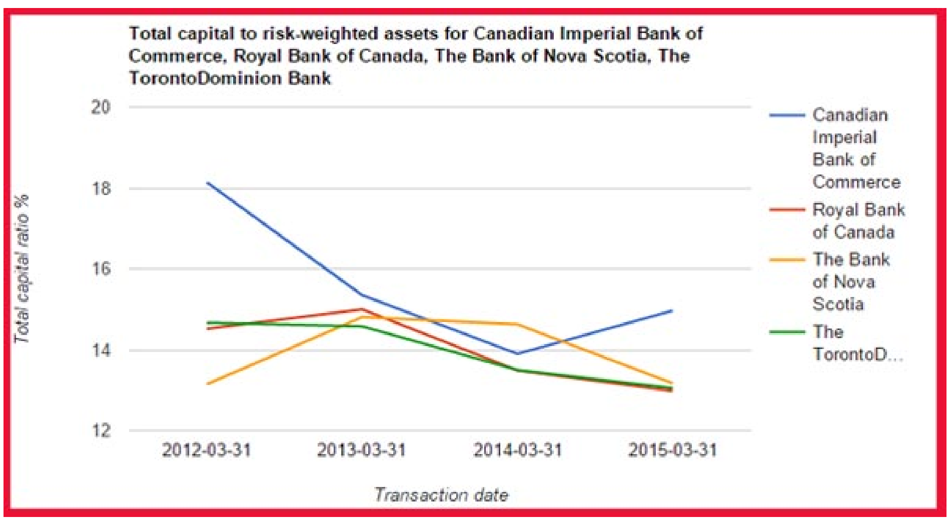

Chart 4, total capital to risk weighted assets

Canadian banks are more than adequately solvent as concludes a recent [liquidity report](). However, as chart 5 shows, share prices are dropping and the ongoing recession is leading to increased risk and the consequential deposit issue.

Chart 5, share prices Canadian banks (source Nasdaq)

To sum it up, some of the factors could precipitate negative rates:

1. Continued growth in corporate deposits;
2. Bank rate drop;
3. Economic pressure resulting from Canada's current recession;
4. Market factors as explained by Josh Galper, Managing Principal, Finadium in his report describing "why excess cash deposits are becoming difficult for banks, and the different paths hedge funds and other unregulated investors can take" (Calypso, 2015).

In the US and Europe, treasury managers have adapted to negative rates by reducing cash through increasing dividends, share purchases, topping up corporate pension plans and diverting cash into mergers and acquisitions: not by investing in future growth as policy makers would wish. (Gordon, 2015)

Clearly treasury managers have responded to negative rates. However, with respect to defined benefit pension schemes the response has been muted. According to Gordon's FT report, "In 2014, the sharp fall in long-term bond yields increased post-retirement benefit obligations of the top 50 companies it rates in Europe by 11 to 18 per cent. Another consequence is low and negative rates allows for "zombie" companies that would not otherwise be viable in a normal interest rate environment. This can lead to over-capacity of which China is a prime example. (Review, 2010)

Treasury managers have responded to regulators and banks which have implemented housing policies, QE, bank rates cuts and risk policies designed to support the banks and stimulate the economy. The problem is that corporations in all regions, apart from China, are not using their cash hoards to invest and grow. Since negative rates have failed to prompt the desired behavior, how would doing the same work in Canada?