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 of 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 maintain high deposits despite 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.

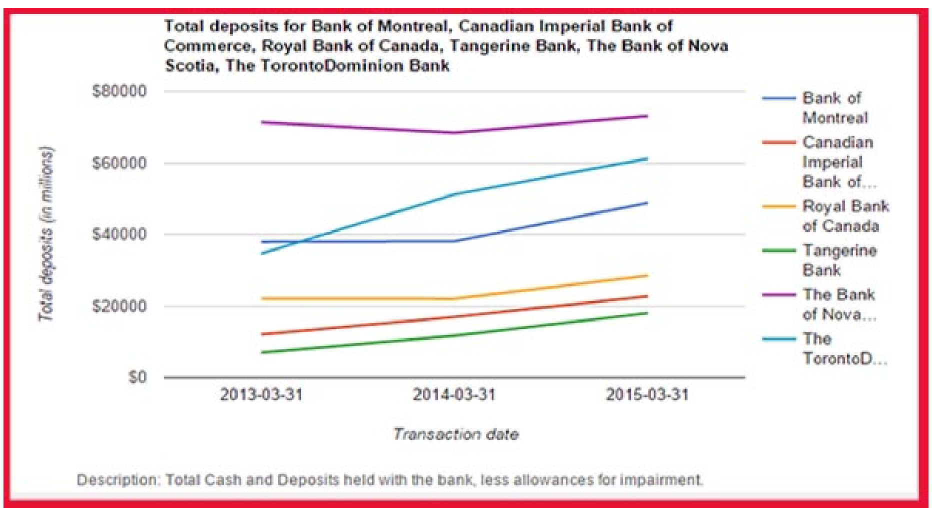

Chart 1, large bank deposit growth

Canada has followed US and European trends, as shown, by having continued to grow their deposit base. Considering the fact that the interest paid on these funds in Canada already marginal, and that banks have enjoyed exceptional capital ratios and balance sheets conducive to lending growth, this has resulted in nothing less than a bonanza of opportunity and profit. Chart 2, 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 driving increased share prices and profitability.

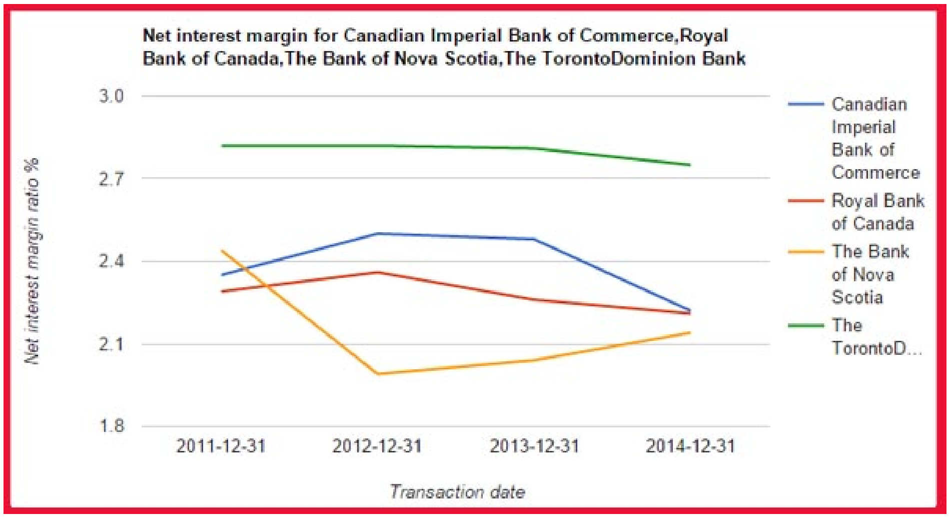

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Chart 2, net interest margin

The term "perfect storm" describes an event where a rare combination of circumstances aggravate a situation drastically. The pressure system has built up and if bank share prices dip and/or risk increases, such that lenders fail to meet regulatory capital requirements this could force banks to restrict lending and compound the problem of excess deposits. This has been the case particularly in Europe for banks like Barclays who are actively discouraging corporate deposits. This is currently not the case in Canada as chart 3 demonstrates strong capital ratios.

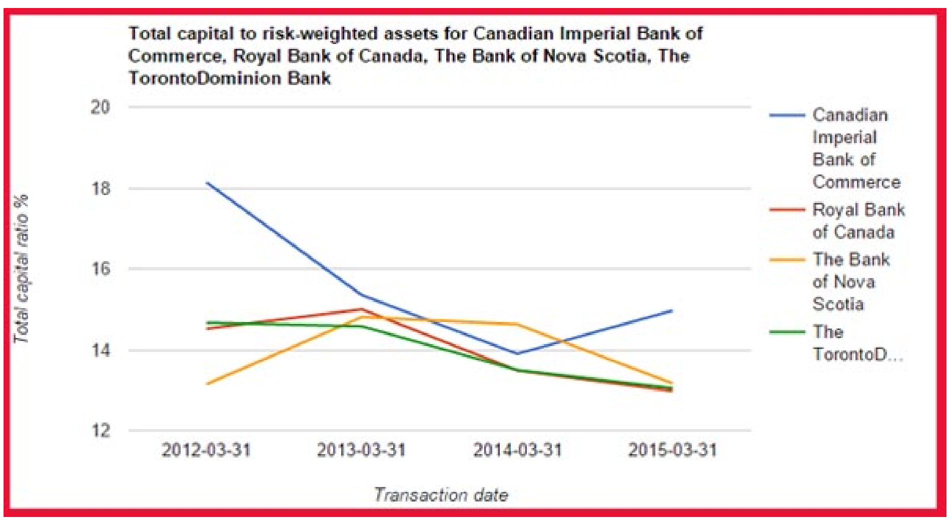

Chart 3, total capital to risk weighted assets

In fact, Canadian banks are more than adequately solvent as concludes a recent [liquidity report](). Despite this, as chart 4 shows, share prices are already dropping in reaction to a weak Canadian dollar and the oil crisis that has resulted in the current recession. Canadian banks are highly exposed to the resource industry which increase overall risk.

Chart 4, share prices Canadian banks (source Nasdaq)

To sum it up some of the factors that 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)

With respect to defined benefit pension schemes treasury managers have no response. 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)

Apart from the risk related to pension obligations, treasury managers have responded to regulators and banks initiatives which include market inflating housing policies, QE, bank rates cuts and risk policies that ensure solvent banks but not corporate investment for growth. The conclusion being that a rate cut will not necessarily provide Poloz the stimulation he craves. On the other hand, a rate rise might have disastrous effects, as per this report: **www.banknews.tv/docs/irr-f.pdf**

It is clear that further rate cuts and certainly negative rates for corporate deposits have not stimulated the European economy, but they will harm pension schemes and further distort markets. Therefore my prediction based on the information at hand is that Poloz will stay the course on the bank rate and we will not enter negative rate territory.