Global Transaction Banking

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INSIGHTS FROM CASH MANAGEMENT, US
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Maximize Short-Term Investments with Foreign Exchange Structures

At 5.25% for the better part of the past year, the fed funds rate has been substantially more appealing to investors than it was just a few short years ago, when it bottomed out at 1%. However, historically speaking, the current rate is still relatively low. Consequently, it's not surprising that many corporate treasury managers are seeking short-term investment alternatives that will allow them to enhance returns over the going market rate—with a guaranteed minimum rate of return that won't jeopardize their principal.

When investing $10 million to $500 million or more, some treasury managers are selecting products that link a foreign exchange (FX) option to the investment structure, allowing them to enhance their company's rate of return on funds invested between three and 12 months.

The Wedding Cake

One popular rate-enhancing product is the "Wedding Cake." This structure provides clients with the opportunity to earn up to 100 basis points—or more—above the current fed funds rate of return, and boasts tiered rates of return contingent upon the FX market.

For example, assume a company invests $10 million for three months. It can put these funds in a standard three-month deposit and earn 5.30%. On the other hand, clients that want to enhance their return might utilize a Wedding Cake investment structure linked to the US dollar/euro exchange rate.

Assume the current dollar-to-euro exchange rate is 1.33, meaning one euro can be exchanged for $1.33. If the exchange rate remains between 1.275 and 1.355 over the three-month investment term, the bank enhances the rate of return by 100 basis points to 6.30%. This translates into $25,000 in supplemental interest.

Building on this example, imagine a four-tiered wedding cake where each layer represents a different bandwidth of FX rates and an accompanying percentage of return. As the permissible bands widen, return amounts decrease.

Assume the 100 basis-point return is the top tier of the cake with the narrowest band of FX rate fluctuation. Working down the layers, if the FX rate stays between a wider margin of 1.27 and 1.36, the bank enhances the rate of return by 50 basis points to 5.80%. Similarly, the client earns 5.30% if the FX rate stays between 1.265 and 1.365, or 4.00% if the rate falls outside 1.265 to 1.365.

In each example, there is zero risk to principal. Clients always receive back their initial investment plus a minimum return of 4.00%.

Range Bonus Deposit Plus

Another option for those seeking to enhance returns on short-term cash is a "Range Bonus Deposit Plus." This structure is ideal for international companies that need euros and US dollars but are indifferent about which currency their money is in at the end of the day; they simply want to earn the highest rate of return possible.

Assume a client invests $10 million for three months with a maximum rate of return of 7.50% if the dollar-to-euro exchange rate stays between 1.30 and 1.40—earning a $187,500 supplemental return. If rates fall outside 1.30 to 1.40, however, the client earns 5.00%—or an additional $125,000.

Interest is paid in dollars regardless of whether the principal investment was in euros or dollars. Principal, however, can be paid back in dollars or euros at the bank's choosing if the option matures below the set conversion rate.

Following the example, if the dollar-to-euro conversion rate is 1.34 at the end of the investment term, the client would receive back its $10 million in dollars plus interest if the structure matures with a rate above 1.34. If the rate falls below 1.34, the bank can offer the client its principal in dollars or euros converted at a rate of 1.34. The lower the exchange rate falls, the more euros a client can receive for the $10 million in principal. For example, at 1.33, the client could receive 7,518,797 euros or receive 7,575,758 euros at 1.32.

Simply put, if the FX market goes below the 1.34 conversion rate, the bank can pay out a more attractive rate of conversion in euros.

Shorter Durations

Corporations seeking investment options for shorter duration periods can select from commercial paper, time deposits, auction-rate securities, Treasury bills and more. These structures all secure principal and guarantee a minimal return, but FX structures can offer the opportunity for a far greater return.

Consequently, companies able to park their cash for three months or more may want to consider maximizing their short-term investments with FX structures.