Cash Deposits – The Risk/Return Dilemma

10% on your cash – but at what risk? The daily papers are full of headline high interest rates that are often not what they seem,

Most TRH clients will have sizeable cash holdings. We view cash deposits as an important asset class that provides:

- Catastrophe cover
- Short term (1-5 years) liquidity to meet cashflow needs.
- The 'risk free' or 'low risk' asset class to balance longer term 'risk' assets such as equities.

The risk/return balance on cash deposits merits consideration in the current economic climate. There are concerns over banks' exposure to toxic structured debt instruments (SDIs); their own mortgage books; and the severe downturn in both residential and commercial property markets over the last 12 months.

This has created the 'credit crunch' with banks urgently needing to attract funds to rebuild their own liquidity. One of the basic business facts is the more you need funding, the more you will pay for it. Hence the high rates we are now seeing for short to medium term deposits. Instant access internet accounts are currently offering over 6% pa and over 7% is available for one year fixed rate accounts.

How risky are these accounts? For smaller deposits there should be no risk up to £35,000 as this is covered by the Financial Service Compensation Scheme which pays out if a UK bank authorised by the Financial Services Authority ("FSA") fails. But a number of TRH clients have many times this amount in cash. They may also be holding money with a UK bank and one of its subsidiaries. Although the subsidiary may trade under a different name, it may not be separately authorised by FSA and therefore only one amount of £35,000 would be payable. For example: a client holding money at HSBC and First Direct would only be entitled to a maximum of £35,000. This is because First Direct is a trading name of HSBC and is not authorised by FSA in its own right.

Some simple arithmetic can demonstrate the risk in terms of interest rates quoted.

A clear measure is the difference between the rate on offer and the risk free rate. A guide to a risk free rate is the yield on 1 year Government Treasury bills which is currently just under 5%. So if the return is 7%, the extra 2% you are getting reflects the risk of the deposit. Put another way, the market is telling us that a 7% one year fixed rate is 40% more risky than the risk free return.

The UK Government Treasury bill gives you 5% and guarantees your money back in 12 months. The worst case analysis on the cash deposit is a 7% return but a downside of losing 100% of your deposit less £35,000 (if your money is held with a bank subject to the relevant compensation arrangements).

So do we need to worry and should we consider safer alternatives? TRH's view is that the major international banks should survive the current problems. In the UK that means RBS, HSBC, Barclays, Lloyds, HBOS and their various subsidiaries such as NatWest, Birmingham Midshires, Halifax etc. Abbey in the UK is owned by Banco Santander, one of the stronger European Banks who might well acquire Alliance & Leicester soon.

It is the smaller institutions we feel need careful consideration before committing substantial deposits. A quick glance at the current top paying 1 year accounts has ICICI Bank UK at 7.20% and First Save at 7.10%. ICICI is one of the biggest banks in India and First Save is a brand of FBN Bank (UK) Ltd which describes itself as the London bank for Nigerians. Now we have no idea if there are any issues with these banks but on the risk arithmetic mentioned above they are at the top end. We would also need to consider the compensation arrangements of such banks.

Another bank near the top is Anglo Irish offering 7.05% for 1 year. This bank is of interest to TRH as a number of our clients hold very substantial deposits there. We have therefore taken a closer look.

The bank is the third largest in Ireland but differs from the other two in that it focuses on lending in the corporate and professional sector on commercial property. A comfort is that it does not have much of an exposure to retail mortgages nor is it involved in the toxic SDIs. However, concerns have been raised as the commercial property market has declined significantly in Ireland and the bank, like its peers, needs to continue to build liquidity in its balance sheet. We attach the latest report from Fitch Ratings. This provides some comfort with the overall comment that 'Anglo's ratings have a stable outlook'.

Clients might wish to review this information and consider whether they may prefer to reduce the risk profile of their cash deposits by taking a lower return and/or spreading the deposit across a number of institutions. Clients with a fixed rate deposit may have early exit penalties, for instance a 60 day interest penalty. We will confirm or review specific details on an individual basis as required.

We can advise on a range of low risk homes for clients' cash holdings ranging from the really secure National Savings to pooled funds that spread the risk over a range of short term liquid and low risk securities.

Please do give us a call if you would like to discuss any aspect of this note or your own cash holdings.

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A regulatory note