MORE TIME FOR OTHER MATTERS

OUTSOURCING DAILY CASH MANAGEMENT ACTIVITIES MAKES SENSE FOR BUSY TREASURERS. BUT WHAT ARE THE OPTIONS? **LIAM WHELAN** OF BANK OF IRELAND FINDS OUT.

It is noticeable how many treasurers have begun to question the time-consuming nature of daily cash management activity. Deciding the optimum tenor for cash deposits, placing the cash on deposit and monitoring the credit exposure to banks can take up a considerable amount of a treasurer's time each day. More and more treasurers are now outsourcing the cash management aspect of their business, either by investing in money market funds or entering into a tailored cash management agreement with a bank.

MONEY MARKET FUNDS. In essence, a money market fund (or a liquidity fund as it is sometimes called) is a liquidity management tool for short-term cash, delivered in the form of a shared investment scheme. It offers a better mixture of security and return than a bank may be able to offer, but without compromising liquidity. The fund, which is open-ended and not tenor-specific, handles the client's cash by investing in a diversified range of high-grade short-term money market instruments, under strict guidelines from the regulatory authorities. The assets of the fund, while managed and controlled by the investment manager, are held separately by a custodian bank. Should the unthinkable happen and both the custodian bank and investment manager fail, the assets are recoverable in full for investors.

In recent years, with the global merger activity of banks and financial institutions, the problem of finding a suitable range of acceptable counter-party banks has increased. Bank credit ratings have declined over the years to such an extent that there are few AAA rated banks remaining. These developments are slowly reducing the treasurer's ability to diversify his or her cash portfolio among an acceptable spread of names. Many of these investors who wish to invest only with the strongest counterparties find there is an ever-reducing number of these and they are offering lower bids for deposits.

Many money market funds carry an AAA rating. This reflects:

- the diversification of the assets held by the fund. Typically, no more than 10% of the funds assets can be invested in any single issuer;
- the credit quality of the assets: the minimum credit grade for assets held in an AAA rated fund is generally Aa3/AA long-term and A1/P1 for short-term assets; and
- the conservative management of the portfolio: the rating agencies impose strict rules around the management of the assets.

In these uncertain times, many treasurers demand same-day access to their surplus cash. They are understandably reluctant to invest in tenor-specific products, such as commercial paper (CP) and term deposits, even though these usually pay a higher return than overnight deposits. Money market funds generally provide a slightly better return on overnight deposits, yet they still offer same-day settlement. This is primarily because a fund will have a large number of investors, all of whom are unlikely to want their cash back on the same day. The fund can therefore safely invest part of the cash in assets with maturities longer than overnight. Since the treasurer is investing in a fund, the return will be the same irrespective of the size of the investment. This is not generally the case with cash deposits. The management fee typically ranges between 12bp and 25bp and is built into the return. On a net basis, the return should still be above the return on a comparable deposit.

TAILORED CASH MANAGEMENT AGREEMENTS. Many treasurers have entered into formal agreements with banks, whereby the bank manages the company's cash on a portfolio basis. The bank effectively acts as an agent for the company when investing the cash with third parties. The surplus cash is invested in a portfolio of certificates of deposits (CDs); CP, floating rate notes (FRNs), fixed rate bonds and traditional cash deposits.

The parameters are set by the treasurer and include stipulations governing the type of instruments permitted, the maximum maturity, the minimum investment grade and the maximum percentage of the portfolio, which can be placed with a single borrower. One of the key issues for a treasurer to consider when setting the cash management parameters is the company's liquidity requirements. A company that may need to call on part of its cash at short notice should ensure that a substantial portion of the cash is invested in short-term deposits or liquid securities. Alternatively, a treasurer may negotiate a committed facility with the bank, whereby the company can borrow to cover any unforeseen requirements.

It is important to note that the company's credit exposure is not to the bank that is simply acting as an agent, but rather to the parties that the bank invests the cash with on the company's behalf. The assets can be delivered to a euroclear account nominated by the company or can be held in safe keeping by a bank.

The company's policy on market risk will greatly influence the composition of the portfolio. Some companies are happy to pick up extra yield by investing in longer-term fixed rate assets, while other, more risk-averse treasurers, will only allow the bank to invest in short-dated paper or FRNs. The credit rating threshold will also greatly influence the potential return. The lower the minimum investment grade for the underlying assets, the higher the potential return. The risk, of course, will also be higher.

The bank will provide the company with regular statements, detailing the income earned on the portfolio and describing the underlying assets.

The frequency of the reports and the level of detail will be agreed between the two parties initially and will form part of the investment agreement. In some cases, the treasurer will appoint a trustee who will oversee the activity of the bank and ensure that none of the investment parameters are broken.

Banks generally charge a fee for managing a client's cash on this basis. A typical fee will be 0.05%, based on the average size of the cash managed. A tailored investment agreement is really only suitable for companies which hold a substantial amount of surplus cash. The threshold is roughly £50m. For portfolios less than this, it will be difficult to earn a competitive return and diversify the portfolio sufficiently. To achieve sufficient diversification, the cash manager will need to invest cash with at least 10 different borrowers or issuers. If the total cash value of the portfolio is much less than £50m, then the value of each single investment will be less than £5m. In this case, it may be difficult to achieve competitive market returns for amounts of this size.

The key advantage of a tailored cash management agreement is that it offers the client a cash management tool that exactly matches the company's requirements, and policy on risk, liquidity and yield, while freeing up a treasurer's time.

RELATIVE MERITS OF OPTIONS.

- **Convenience.** Both structures offer a high level of convenience for the treasurer. There will be some work around setting up a tailored investment agreement with a bank. A formal cash management agreement needs to be set up detailing the investment policy, the reporting requirements and the fee structure. With a money market fund, all these issues will already have been addressed. The treasurer simply has to fill in the application form and transfer cash to the fund. In summary, after the initial negotiation surrounding the establishment of a tailored cash management agreement, it compares at least as favourably with a money market fund in terms of convenience.
- **Return.** A money market fund aims to outperform the return on short-dated cash deposits – generally the overnight rate. With a tailored cash management agreement, the treasurer can choose a benchmark that best suits the company's liquidity and risk profile. For example, if the treasurer knows that the company's surplus cash will not be required for the next six months then the six-month cash rate might be an appropriate benchmark. The investment policy will give the cash manager a mandate to invest in longer-term assets with the opportunity to earn a higher return than that for a typical money market fund.
- **Minimum amount.** Since most money market funds have a large number of investors, there is greater flexibility around the minimum amount invested. The minimum subscription amount is usually £1m. There is no maximum amount. As a tailored investment agreement is structured for a single client, the minimum investment amount will be significantly higher at about £50m. Once a tailored fund is set up, it should be possible for a treasurer to invest and withdraw amounts of £1m.
- **Security.** Both structures carry the same underlying credit risks. In both cases, the investors credit risk is with the underlying assets, rather than with the fund or the bank that is acting as cash manager. The diversification and credit quality of the underlying assets will influence the credit quality of the fund. However, most money market funds carry a formal rating from at least one credit rating agency. Many conservatively managed money market funds with good asset diversification carry an AAA credit rating. In theory, a tailored investment fund could apply for and achieve a rating but, for a fund tailored for a single investor, this would prove expensive.
- **Liquidity/flexibility.** Money market funds offer same-day investment and redemption. With tailored investment agreements, the treasurer will set the investment policy to exactly suit the company's liquidity and risk profile.

To match the unique risk/reward criteria of a specific group of customers – who need the credit comfort of a portfolio of AAA assets, but are prohibited under current legislation from investing in money market funds – variations on a tailored investment agreement and a money market fund are available.

The investor places cash, for a period of one to 364 days. Each deposit is backed by AAA rated bonds, generally government bonds. These bonds are held in an escrow account under the supervision of a third-party trustee.

In the event of default on the deposit, the investor has full recourse on the bonds. The minimum deposit is usually £1m, and there is no maximum amount. Many cash managers find this product attractive, as it combines the positive features of a money market fund (security, yield and liquidity) with the flexibility around tenor and return that best matches the investors credit and liquidity criteria.

DECISION TIME. A treasurer who is considering outsourcing cash management business needs to evaluate the relative merits of:

- a traditional money market fund which offers same-day liquidity, can be used for relatively small amounts and carries a recognised credit rating; or
- a tailored investment agreement which can exactly match the company's liquidity profile and credit risk requirements.

By selecting the most appropriate investment vehicle, the treasurer will ensure the company's surplus cash is fully optimised.

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