southern European economies to continue, as do the financial markets, judged on those governments' German bund spreads. Commodity prices have reacted after 2008 although they are not at their peaks. Undoubtedly this will impact on OECD inflation although whether via inflation or stagflation is uncertain.

The CBI growth forecast for the UK is 2%, which is more or less the UK trend level but with a slower recovery than from previous recessionary periods in the 1980s or 1990s. However, UK consumer price index inflation should decline back to a 2% level in 2011/12 once the recent VAT increase has been factored out. UK growth will have to be driven by investment and trade because consumers are hurt, the government isn't spending and inventories are being held down. Average earnings are stable despite the inflation outlook, so household purchasing power is being eroded. Unemployment may rise further to 2.75 million, with limited employment growth until 2012/13, although there will be some growth in the private sector to offset public sector job losses. On interest rates, the CBI expects base rate to be 3% by the end of 2012. Treasurers will need to watch yield curves closely to see whether this means a flattening of the curve or a complete upwards shift.

Peter Matza is head of publishing at the ACT.
pmatza@treasurers.org

Buffer building

DAVID MANSON EXPLORES THE ARRIVAL OF THE LIQUIDITY BUFFER AND LOOKS AT POSSIBLE SOLUTIONS FOR TREASURERS FACING A CHANGED WORLD OF LIQUIDITY.

The annual ACT Cash Management Conference highlighted the importance of effective management of cash and liquidity for treasurers, especially when managing multiple sites. This was certainly confirmed through the voting session at the start of day one – 60% of delegates rated cash management as their main priority. The common view is that the financial crisis is easing for a number of business sectors; however, some are still feeling the effects. Against this backdrop of a changing economic landscape, the treasury function and the role of the treasurer has increased in profile.

A treasurer's ability to manage a company's working capital and liquidity is key to achieving business growth and meeting the company's objectives. In addition, more stringent regulations, such as Basel III, will drive companies to review existing polices and processes as well as achieve a thorough understanding of counterparty risk and how best to mitigate that risk. For those corporates at the conference, over 50% have changed their counterparty risk profile over the course of the past 12 months.

Another theme at the conference was the stability of the banks' balance sheets. This continues to be a primary focus for the UK's Financial Services Authority (FSA), and remains a key concern for 80% of treasurers surveyed. A number of new regulations and guidelines have already been introduced or are on the horizon. These regulations are designed ultimately to strengthen banks against future banking collapse but they also bring with them a number of operating implications for both corporates and banks to consider.

LIQUIDITY BUFFER

Prior to the financial crisis some financial institutions were deemed to have held inadequate liquidity reserves. The FSA's requirements are designed to allow an institution to survive a severe liquidity stress as a going concern. This should improve the resilience of the UK financial system, but this comes at a cost as the assets held in liquidity buffers are low-risk and low-yield.

Then there are the liquidity provisions of Basel III, which principally cover a mandatory liquidity stress test and a long-term funding ratio. The former is similar to the FSA's approach, but has a one-month time horizon, not three months. The latter creates a requirement for long-term assets to be funded with longer-term liabilities. These regulatory initiatives are intended to improve the resilience of the banking system by reducing reliance on short-term funding. This is likely to be reflected in the price that banks are prepared to pay for short-term deposits.

Banks now have to satisfy new capital requirements and hold a capital liquidity buffer, which in today's environment is a regulatory requirement that all banks and building societies operating in the UK must comply with. All banks regulated by the FSA are required to hold significant liquidity in reserve to meet outflows in the event that the institution, the market or both suffer a liquidity stress. These reserves take the form of highly liquid assets, typically cash with central banks or G7 government securities. Those assets can be used during a stress period, allowing the institutions to meet their obligations by liquidating these instruments.

MANY BANKS HAVE LOOKED TO DEVELOP INVESTMENT OPTIONS FOR THEIR CLIENTS OUTSIDE THE BUFFER PERIOD AND HAVE ENHANCED THEIR TERM RATES FOR MATURITIES OF 90-100 DAYS OR MORE.

At Barclays Corporate we have embraced these requirements to ensure compliance and to strengthen our balance sheet. As at 31 December 2010 the Barclays liquidity buffer was reported as circa £154bn.

The FSA's regulations require institutions to survive a funding stress that lasts three months. This means that funding with duration of less than three months is less attractive to the institutions as it will need to be reflected in their buffer requirements.

As a result of the FSA regulation, many banks have looked to develop investment options for their clients outside the buffer period and have enhanced their term rates for maturities of 90-100 days or more. This lets banks offer an attractive alternative but at the same time a simple and safe means of investing surplus funds that can readily be accessed (see box below).

The corporate benefit from this is that those banks, such as Barclays, that demonstrate adherence to the new regulatory regime will continue to have a strong and healthy balance sheet. This will drive a deeper relationship between corporates and the banks that can meet their needs.

This reserve for bank liquidity is not limited to the UK. Regulators across the globe are enforcing similar policies. The way in which banks pay for this increased capital requirement will no doubt impact how they operate. And that in turn will drive and shape their future offerings.

Alternative bank investment options

IN ORDER TO MEET THE REGULATORY REQUIREMENT WHILE PROVIDING CORPORATES WITH AN ENHANCED YIELD, SOME FINANCIAL INSTITUTIONS HAVE DEVELOPED ALTERNATIVE INVESTMENT STRUCTURES.

FIBCA

For example, at Barclays, the Corporate Flexible Interest-Bearing Current Account (FIBCA) allows the corporate client to identify a likely range of balances on an operating account during the medium term (minimum one year). The corporate can then receive a basic rate of monthly interest during the year on its balances, with an additional bonus over the average balances paid at the year-end. This allows clients to benefit from instant access to their deposits in the event of market and/or institutional stress while planning for enhanced yields for longer-term deposit activity, should the markets remain stable.

BARCLAYS CORPORATE 100 DAY NOTICE DEPOSIT

The Barclays Corporate 100 Day Notice Deposit offers corporates a competitive rate of interest on balances of £1m or more. The interest rate is fixed monthly based on three-month LIBOR and the margin is agreed up-front upon the initial deposit of funds. The simple nature and structure of this open-ended type of fund makes it an ideal solution for a corporate's surplus liquidity.

EASY, EFFECTIVE MONEY MANAGEMENT

Today's environment is driving treasurers to strive constantly towards operating a simple yet at the same time effective treasury management model. Barclays' 100 Day Notice Deposit offers treasurers the ability to add to the fund at any point as well as the flexibility to withdraw part of the balance, negating the need to break the overall deposit. The fund offers corporates the ability to have multiple notices of withdrawal and the ability to pre-book notice of withdrawal.

Treasurers can therefore plan in advance for key dates such as year-end to allow for payment of taxes. Once Barclays is instructed to withdraw funds, the amount specified will begin the 100-day notice period and the funds are held in a 100 Day Barclays Treasury Deposit, with the rate of interest fixed at the rate on the client's 100 Day Notice Deposit when notice of the withdrawal was received.

The 100-day notice account means that the financial institution is able to offer a higher rate of interest as the notice period exceeds the FSA's stress horizon.

COUNTERPARTY RISK MANAGEMENT

Given the market conditions and unprecedented regulatory change, corporates should review their current counterparties. As previously highlighted, over 50% of delegates have changed their counterparty limits over the past 12 months and we expect this trend to continue.

The increased focus on counterparty risk management and the current ratings of banks may require treasurers to review their treasury polices. As discussed at the conference, there is an increasing view that banks are treated in many ways as just another debtor, as some financial institutions have lower credit ratings than their corporate clients.

Following the recession, many corporates have reviewed their banking counterparties to ensure that their banking group can meet their current and future needs. In some cases this has increased the number of banks used, particularly where the corporate used to place the majority of its business with one or two banks. In others, the number of banks has decreased where the financial strength of previous providers was in doubt.

Banks are now more transparent when they are talking to treasurers about their own liquidity management. This includes discussing how banks fared in the European stress tests last year, the strength of the survivors of the crisis and which institutions then can offer security and stability. These conversations can lead to a strengthened relationship between corporates and their banks. The priority for treasurers today is ascertaining the best combination of security, liquidity, relationship and sovereign risk while maximising the yield available.

Managing counterparty risk has never been more difficult. Bank ratings are not always a true reflection of the risk, particularly when factors such as credit default swap (CDS) pricing are taken into account.

WHAT ARE CDS RATES?

An institution's CDS rate reveals the cost to a wholesale investor of insuring an investment in that institution, against the risk of the investor's capital not being returned.

If, for example, ABC plc has a CDS rate of 2% and an investor has put £10m into the company, then it would cost that investor £200,000 annually to protect itself against the risk of not having the £10m returned.

As with any insurance contract, if nothing untoward happens, then the investor (known as the protection buyer in the CDS market) does not get that 2% back.

But if some adverse event were to happen to ABC plc – if, for example, the company failed – then whichever institution the investor had taken out the insurance with (known as the protection seller, and typically another investor, bank or financial institution) would be liable to repay the capital to the investor.

WHAT DO CDS RATES TELL US?

The higher the perceived credit risk of an institution, the higher the insurance cost will be. Accordingly, whereas a credit rating indicates a rating agency's assessment of the credit risk of an institution, CDS rates indicate the wholesale markets' assessment of that credit risk. However, the credit rating is a snapshot – an assessment as at the time of last review – whereas CDS rates provide a real-time assessment and can and do change constantly.

By extension CDS rates also serve as a very good proxy of the credit component of an institution's wholesale funding costs and hence indicate how these costs vary over time and between various institutions.

This is because, in theory, if an investment is risk-free, then there is no risk of capital not being returned and so the cost of insuring any risk-free investment is zero. If an investment is not risk-free, however, a wholesale investor will expect the return from it at least to cover the cost of insuring against the risk of the capital being lost.

Hence the CDS rate represents the additional return a wholesale investor expects an institution to pay to cover credit risk. The more risk an institution is perceived to run, the higher the insurance/CDS rate, the greater the return the investor will expect and the higher the funding cost.

OVER 50% OF DELEGATES HAVE CHANGED THEIR COUNTERPARTY LIMITS OVER THE PAST 12 MONTHS AND WE EXPECT THIS TREND TO CONTINUE.

IMPORTANCE OF TREASURY POLICY AND ONGOING REVIEW

A review of treasury policy should use and incorporate best practices and include the following:

- update and review to ensure current market conditions are taken into account;
- regularly monitor counterparty ratings and their risk positions in accordance with current treasury policy;
- understand the basis for credit ratings and what they mean;
- monitor exposures in a consistent manner;
- dedicate time and resources to monitor counterparties proactively – identifying potential problems before they reach the critical stage;
- invest in financial instruments that will help identify exposures as visibility of cash is critical;
- set the policy relating to deposits invested by subsidiaries; and
- review the return profile to take advantage of arbitrage opportunities for market instruments.

Treasurers should re-affirm within their business the attitude towards yield versus credit risk. Businesses should question why some institutions pay relatively high returns for funding, especially when the regulatory regime penalises banks for relying on short-term funding. Efficient cash management is even more critical in a low-interest rate environment, and treasurers should ask their banks to explain what products they can offer to improve cash management capabilities.

David Manson is head of liquidity management at Barclays Corporate.
David.manson@barclays.com
www.barclays.com

Primary objectives

HARCUS COPPER LOOKS IN DETAIL AT HOW TO IMPLEMENT A SWIFT SOLUTION.

The treasurer's role in positioning the business for growth and improved profitability is neither easy nor clear-cut. The treasurer needs to ensure the treasury management model brings together all the latest technologies, systems and services available, along with best practices adopted by successful companies, so that the highest possible levels of effectiveness and efficiency can be achieved in cash and treasury management.

The development of the SWIFT (Society for Worldwide Interbank Financial Telecommunication) corporate connectivity solution means that SWIFT can provide interoperability between a company's core enterprise resource planning (ERP) and treasury management systems (TMS) and the bank, helping treasurers to meet their key objectives.

In this context, the primary objectives of the corporate treasurer are typically:

- to maximise control of cash and minimise financial risk by ensuring that adequate policy standards and controls are present in every business process and business structure generating cash or creating financial risk;
- to be the strategic business partner of operating units and subsidiaries;
- to operate an efficient treasury department; and
- to ensure regulatory compliance with all accounting and operational standards.

Every company will have different requirements when it comes to their treasury management model. The financial flows of the business, the financial position, the level of centralisation, the technology and systems infrastructure and data availability, the company culture and attitude to risk, and whether the corporate treasury department is a profit or cost centre will all have an effect.

Leading banks, including Barclays Corporate, provide support in developing overall corporate treasury policies and strategies, as well as offering some of the most advanced and effective cash management systems and services currently available. Driving efficiencies through payment processing is an integral component of a successful treasury management model, and treasurers are striving to achieve straight-through processing (STP) across all the systems and services they use.

STP remains high on the list of key objectives for treasurers. Automation of processes easily outweighs the legacy of manual processes in terms of efficiency and overall