The Association of Corporate Treasurers (ACT)

Report

Credit crisis and corporates – funding and beyond

TREASURY, RISK
AND FINANCE
PROFESSIONALS

ACT

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www.treasurers.org/creditcrisisimpact

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The Association of Corporate Treasurers

The Association of Corporate Treasurers (ACT) is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences and publications – including The Treasurer magazine.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf

Interviews were conducted and the report written by Gerry Bacon, John Grout and Martin O'Donovan. Their comments, not representing what was said by interviewees, are identified in the text by "*Observation:*"

This report is a synthesis of the views of the members interviewed. Views expressed in the report are not necessarily the views of the ACT. The report does not constitute advice or guidance.

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Credit crisis and corporates

Executive Summary

The Association of Corporate Treasurers (ACT) is presenting this report on the impact of changed banking and market conditions on the treasury plans within the UK's top 350 quoted businesses following a series of in depth interviews with ACT members.

All respondents recognise that conditions are unquestionably tough now but it is not that everything has ground to a halt – there has even been a fair volume of bond issues in January this year. Many corporates took advantage of benign conditions in 2007 and earlier and over funded. Some renewed facilities during summer 2008, post credit crunch, but sensibly assuming that things would not get better quickly. From our respondents the majority had their first requirement for refinancing in 2011 or later.

Finding a bank prepared to do new business is difficult, and even with the apparently willing ones the approval process within banks is unclear and unpredictable which can lead to uncertainty, delays and frustration. Relationships are key and banks are even more conscious of their "share of wallet". However with the right match between bank and customer, deals can be done. Expectations were that even on refinancings the amounts available would almost certainly be scaled back as would available maturities.

The ability to raise a large M&A facility quickly and easily is now seen as a real issue. Project finance too was identified as a problematic area. The lack of availability of bank credit was exacerbated by lenders' bias towards supporting domestic business.

Clearly borrowing margins have risen. As a rule of thumb margins will be up by a factor of 5 times from the previous lows. A retreat from these extreme levels is not expected until 2010 or later and even then margins will not reach the very low 2007 levels.

With banking market capacity much reduced for the foreseeable future the capital markets are seen as a replacement funding source even for those that have traditionally not made use of bonds. Some unrated corporates are expecting to seek their first rating in order to gain access to new sources of funding.

Perhaps reflective of the size of corporates surveyed and the fact that they have professional treasury departments, there were few problems with withdrawal of uncommitted lines. These were still in active use for bonding and letters of credit, and where there were cutbacks often it was to recognise that they were surplus to requirements.

In the foreign exchange markets there had been very little disruption to the spot markets. Forward deals and swaps however had been and still were subject to difficulties – disparate pricing between different banks, lack of willingness to take on the positions and delays in dealing driven often by the need to get additional credit headroom. Comparable conditions existed in other derivative markets.

Counterparty credit exposure, cash management and working capital management were all getting proper attention, and, perhaps surprisingly, the experiences on customer payment behaviours were good.

All accepted that bank capacity was going to be constrained for many years and hence some material de-gearing within the corporate sector was expected.

1 Background

1.1.1 The Policy and Technical Committee of the Association of Corporate Treasurers ('ACT') has undertaken this study to summarise the impact of the 'credit crisis' on its members and their employing entities, in order to provide

(i) a way for members to share experience anonymously and to suggest ways members could take actions to mitigate some of the credit crunch impacts; and
(ii) information which may be useful to policy makers and a wider public.

1.1.2 Rather than a "tick box" approach, in depth interviews were conducted with 43 senior Treasury professionals drawn from members at UK corporates, covering organisations in the FTSE 100, FTSE 250 and others. A size breakdown of those corporates consulted is attached in Appendix 1. Many of those corporates surveyed fund themselves in global markets so our commentary usually relates to global markets and banks, not solely to UK markets and UK banks.

1.1.3 We have deliberately not interviewed corporates publicly in distress since the aim was to establish what has happened to banking conditions and behaviour for "normal" corporates.

We report the findings under the following major headings

2 Major Issues

3 Feedback about Banks

4 Derivative Markets

5 Expectations for the future

6 Recommendations

7 Appendices

2 Major Issues

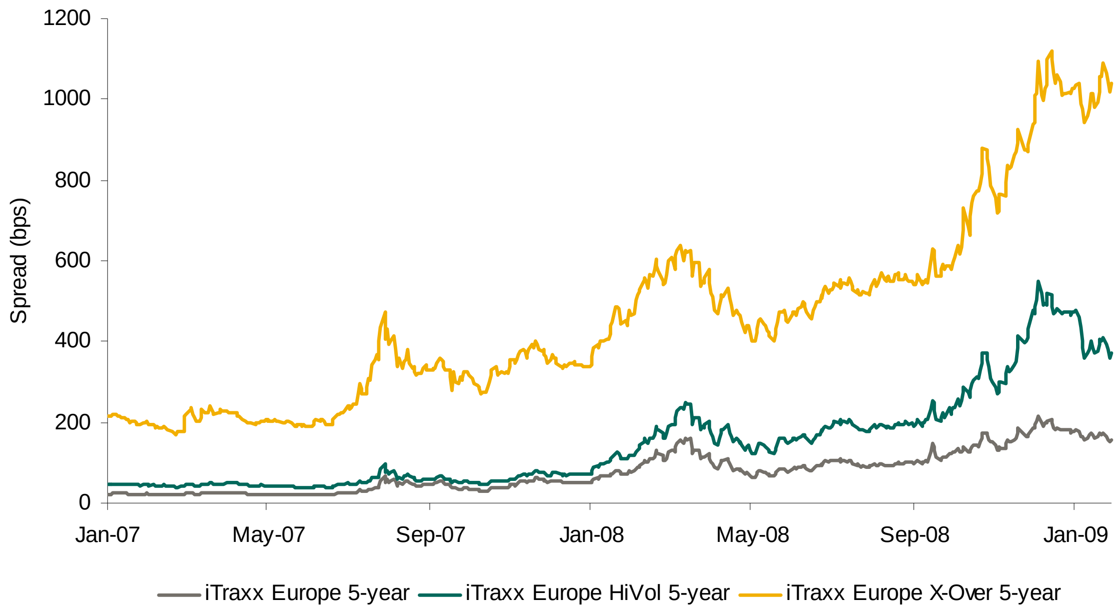
2.1 Price of Credit

2.1.1 All borrowers have witnessed a severe increase in their borrowing margins (i.e. the credit spread over the appropriate benchmark cost). Whilst this started in July 2007, with a slight abatement in autumn 2007, most of the increase has occurred since Lehman Brothers collapsed in mid September 2008. No one surveyed thinks borrowing margins and conditions will return to their long run averages during 2009 and most think it will take until, at least, 2011 before we see much improvement.

2.1.2 Before the credit crisis borrowing margins were generally running at historically low levels for borrowers. As a broad rule of thumb, members' borrowing margins have generally increased to somewhere between 3 to 5 times their corporate's pre-crisis levels. Commitment and arrangement fees have increased along with borrowing margins.

2.1.3 The graph below shows 5 year credit spreads from three different credit baskets: the iTraxx Europe (125 investment grade names), iTraxx Europe HiVol index (top 30 highest spread names, investment grade or unrated, from iTraxx Europe indicies) and the iTraxx Europe crossover (50 sub investment grade names) for 2007 and 2008.

Graph 1: Borrowing margins



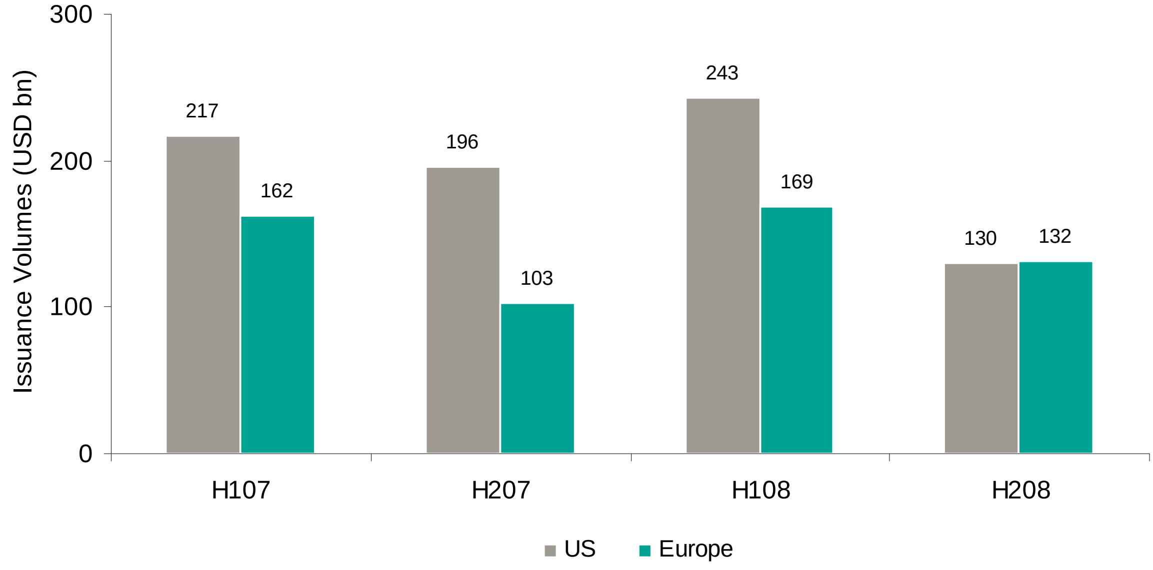
2.1.4 This significant increase in the cost of borrowing will require certain businesses operating with low profit margins in competitive industries and with relatively high levels of gearing to re-consider their business model and/or capital structure. Examples may be seen in the retail, automotive and construction sectors.

2.2 Availability of Credit

2.2.1 This has affected different organisations depending on their access to capital markets and to some extent industry sector.

2.2.2 Although bond markets have been very volatile during 2008 both in terms of timing of accessibility and pricing, large cap corporates, particularly utilities or quasi utility corporates have been able to access the public bond markets, albeit at much higher borrowing margins, particularly if rated BBB+ or better. The graph below shows that volumes of corporate issuance in the US dropped off in the second half of 2008 compared to the previous three half years. But the € market has been strong. New investment grade corporate bond issuance in € for the first four weeks of January 2009 reached the same level as the first fifteen weeks last year, amounting to €35bn. Similar trends have been seen in £ bond markets but with relatively lower volumes. Lower rated (BBB) investment grade borrowers have also successfully issed bonds in 2009. In addition, the high yield markets have reopened in the US and in Europe in January 2009 with nearly $3bn of new issuance in 2009 even from lower rated B/CCC+ issuers.

Graph 2: Corporate bond issuance

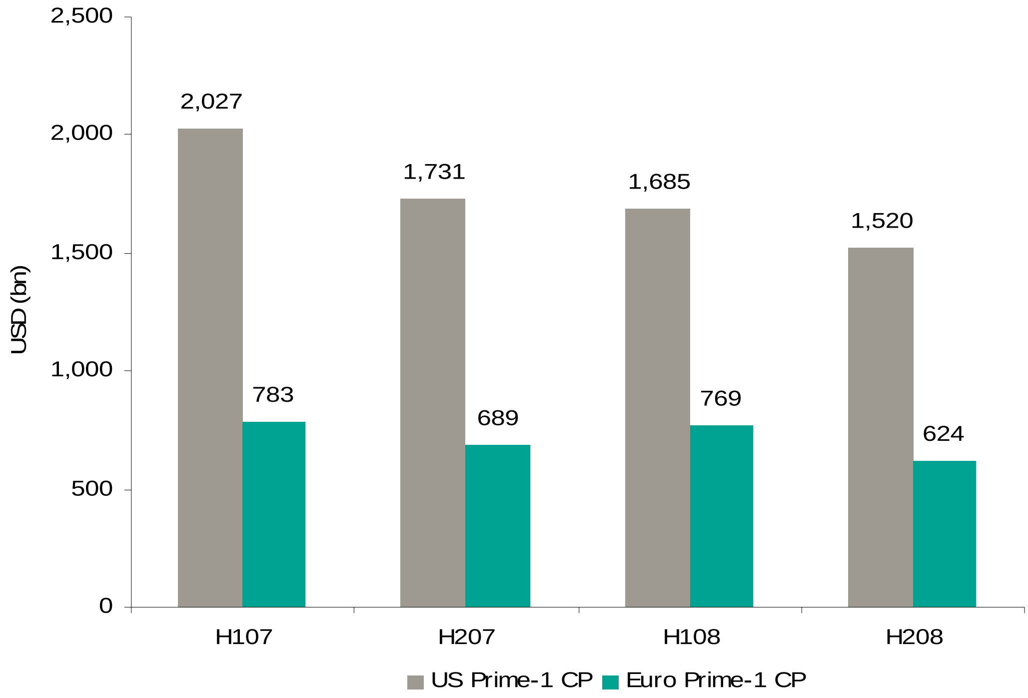


2.2.3 However, even though there has been high volatility in equity prices the convertible markets are very quiet due, in part, to a lack of investor interest particularly from hedge funds. Since September 2008 there has only been around $2bn of new issues globally.

2.2.4 Some borrowers are considering issuing in the US private placement (bond) market which has some appetite and they would consider private placements in other markets if possible. However, feedback suggested that because the private placement markets usually demand more onerous documentary conditions than in the public bond markets, problems can be encountered if such conditions need changing in the future.

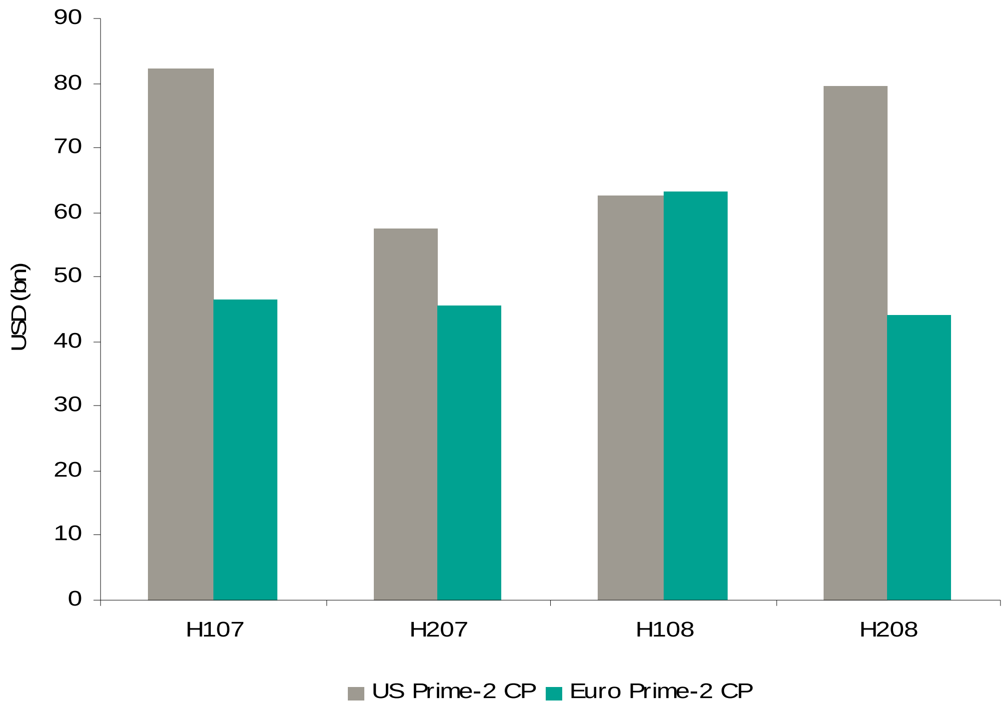
2.2.5 Commercial Paper market outstandings are shown in the following two graphs where it is worth noting that short term prime 2 borrower outstandings are usually less than 10% of short term prime 1 borrower (long term ratings single A or better) outstandings. In the US CP markets, prime 1 rated corporate borrowers have had few problems raising capital but maturities have been shorter than usual for everyone and the two to four week period post Lehman was difficult when investor interest was muted. Generally, outstandings in the US have declined but part of this is due to reduced appetite from investors for financial issuers. In the euro CP markets up until Lehman's collapse outstandings had held up well for prime 1 borrowers albeit recognising that euro markets are smaller than US markets. Banks and Asset Backed CP issuers have suffered considerably in all CP markets.

Graph 3: Prime 1 commercial paper outstanding



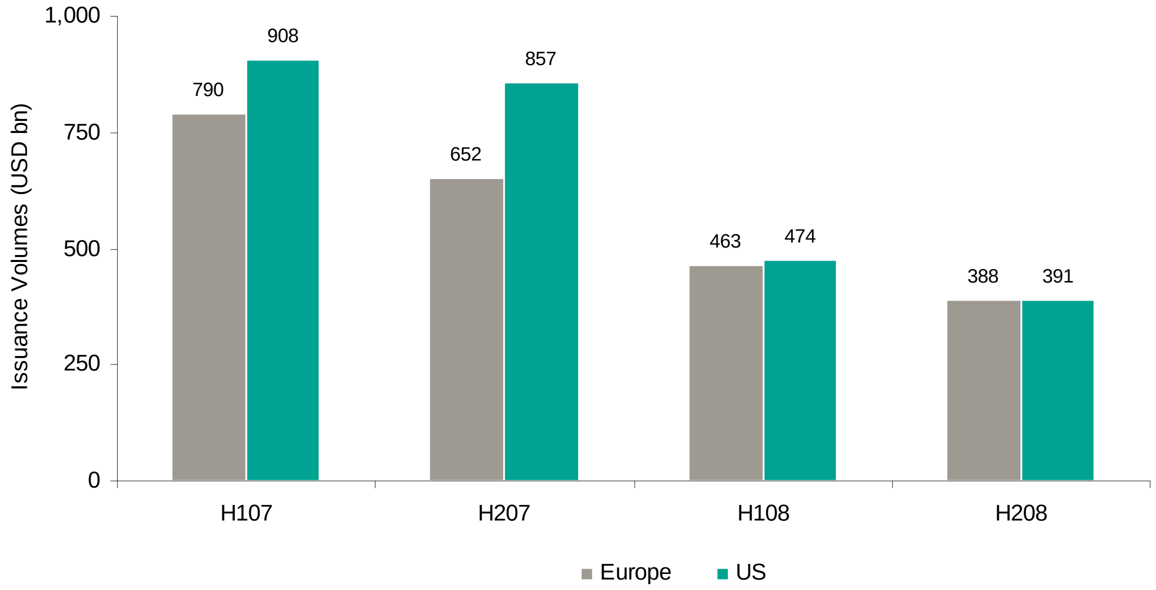
2.2.6 Since Lehman's collapse prime 2 corporate borrowers have found it harder but well known corporate borrowers, either through having a strong regional brand or being a regular issuer, have fared reasonably well.

Graph 4: Prime 2 commercial paper outstanding



2.2.7 Bank capital adequacy issues have reduced bank appetite for corporate lending, as evidenced by the amount of new syndicated loans for corporates in Europe and US markets, shown below. Significantly, the reduction in loans started in early 2008 well before the Lehman collapse in mid September.

Graph 5: Corporate syndicated loan volumes (new issuance)



2.2.8 Corporates that do not have access to the bond markets, because they lack name recognition, are too small or do not have a sufficiently high credit rating, are consequently highly dependent on bank finance. For them, the availability of medium term debt from banks has undoubtedly reduced. *Observation:* These smaller corporates lack the volume of ancillary business to support bank lending in difficult times and their loans are too small to have a ready secondary market, making them less attractive customers for banks.

Maturities/commitment levels

2.2.9 For corporates who have renewed or are about to renew a committed bank facility (syndicated, club or bilateral) many have found or are finding that some banks are unwilling to renew and most banks are looking to scale back their participation. In many cases borrowers are having to accept fewer banks and lower commitments resulting in smaller facilities. Maturity periods for loan facilities are also reducing. Between 2004 and 2007 banks were prepared to extend the maturity period of loans from the usual maximum period of five years to seven years. The maximum period at present seems mostly to be three years.

2.2.10 There are many reports of corporates losing banks with whom traditionally they have had relationships due to a combination of :

- mergers of banks,
- banks shrinking their balance sheets,
- banks focusing more on profitable ancillary business,
- banks retreating to markets they know best – their home markets – for reasons of prudence and their need for support from their home authorities
- banks being reluctant to lend due to higher perceived risk in certain industry sectors e.g. retail, automotive and construction
- and, lastly, tightening of credit standards.

Facility renewals

2.2.11 The few corporates with significant facilities maturing in 2010 are looking to renew facilities or put in place new ones in H1 2009 to make more robust the “going concern” basis for reporting at the end of H1 2009. This requires having an expectation of sufficient liquidity for at least 12 months from the date the auditors sign the accounts. Some are looking at forward start agreements. For the majority of corporates the first maturities will be in 2011 or later.

Uncommitted lines of credit

2.2.12 Banks have also cut uncommitted lines which have traditionally been used by a small number of borrowers for managing working capital but this is by no means across the board. Uncommitted lines for straight forward lending do still remain available but in lower amounts. 81% of corporates interviewed had experienced no change or only a marginal reduction in uncommitted lines. Some comments were received positively about re-introducing a scheme akin to the old acceptance credit markets to assist corporates and their banks to finance trade related working capital

Immediate funding needs

2.2.13 Corporates in the survey were, in the majority of cases, adequately funded for the immediate future although a small number had work to do during 2009 (see 2.2.14). In part this is due to our sample excluding 'distressed' corporates and in part because the corporates were sufficiently large to be able to employ professionally qualified treasurers. Easy availability of credit and at good margins in the period before summer 2007 meant that most corporates had put in place committed bank facilities which contractually oblige the banks to lend at specified borrowing margins, and the banks (Lehmans aside) were fulfilling their obligations. None of the corporates surveyed had maturities before 2010 and for 70% the earliest maturities were 2011 or later. However, we were a little surprised to hear that even a small number of corporates were prepared to wait until nearer to maturity of the facilities before starting serious negotiations with banks. A modest number had already renegotiated facilities using forward starting dates to ensure banks' commitments were maintained in sufficient volume

Support for trade related facilities

2.2.14 There has also been positive feedback about the continued availability of letters of credit and performance bonds to support international business although pricing is moving upwards. Uncommitted lines set up to provide letters of credit or forms of trade related bonding do not appear to have been cut back other than in a small number of cases. Furthermore receiving banks and firms seem agreeable to the names of banks issuing letters of credit, performance type bonds and guarantees with the perturbations seen last autumn now over.

M&A funding

2.2.15 Lack of ready access to quickly arranged mega-facilities to support M&A is a limiting factor for such deals. Previously, when M&A finance was being negotiated, the expectation was that it would need to be short term bridge finance. There would be a weak commitment from the corporate to "term out" the debt in bond markets or to generate funds to pay down the bridging by disposals or by using cash flow. Facilities would be agreed over a couple of days.

If such finance is available now, it takes longer to organise and needs more banks as they individually reduce their "ticket" size and will not underwrite more than their maximum "take and hold" commitments. Banks are looking for more certainty, requiring greater commitment to the take out route and structured quarterly ratchets to increase the pricing and discourage delays. As previously, banks require borrowers to have a credit rating so as to give access to the public bond markets to facilitate paying down the bridge financing.

Signs of nationalism

2.2.16 While some banks are "taking their ball home", foreign banks are still lending to the central treasuries or holding corporates, if the corporates can demonstrate ancillary business for the bank in its home territory "If you tick all the right boxes then they will lend," said one treasurer.

2.2.17 In the other direction there can be more intractable problems in getting project finance in emerging markets where the local market is insufficiently developed and the international banks not willing to lend since they are giving preference to funding businesses in their domestic markets.

Credit Insurance

2.2.18 For some businesses availability to suppliers of credit insurance seems necessary for the firm to receive credit. There were instances reported where the effects of withdrawal of credit insurance were being felt, although in many cases the credit was continued. In the past those corporates whose suppliers took out credit insurance on them had very little contact with the credit insurers. More and more the credit insurers are seeking meetings with the management of the corporates they cover.

Working capital management

2.2.19 Some corporates are spending more effort internally managing their working capital. However not all corporates are focusing on this yet admitting that greater attention will be applied as 2009 unfolds. For some treasurers quick wins have been achieved through making sure that pockets of cash in subsidiaries have been centralised and put to use reducing borrowings. Experience of customers paying later is muted. In some industries corporates are looking at business opportunities by working with and not squeezing suppliers and customers. In some cases corporate have offered finance and benefited from this action financially or from improved business relationships. 78% of corporates surveyed had not experienced any deterioration in customer payments.

Share buybacks

2.2.20 The more significant action being seen to conserve cash is the cessation of share buyback programmes and reduction of discretionary capital expenditure. Additionally, rights issues, placements and dividend cuts are being contemplated and discussed and a number of corporates have already announced cuts in dividends for 2009. It is hard to identify how much of the cash savings being planned by corporates is driven by the lack of liquidity in the markets or caused by the recession as product demand falls.

Summary

2.2.21 In summary, the larger cap corporates which have multi-geographic businesses and can offer banks profitable business and which have access to bond and commercial paper markets are in a relatively strong position. However, smaller cap corporates with little ancillary banking business, without access to bond/CP markets, or in difficult industry sectors are facing a nervous 2009 in terms of raising capital.

2.3 Counterparty Risk

Clarity of governments' support for banks across the world

2.3.1 There is uncertainty amongst members about the ways that different governments have supported banks through capital injections, managed asset acquisitions (e.g. TARP) and guaranteed retail depositors. For example, whilst there are similarities in the way European governments have offered to guarantee bank deposits, the amounts vary from one country to another. Further moves are expected from authorities around the world in the course of 2009.

2.3.2 More generally, it is not entirely clear which banks are being 'guaranteed' by governments. For example in the UK it is not seen as clear what can be assumed from the fact that the government has injected preference shares and ordinary shares into certain banks but not others.

Counterparty risk management

2.3.3 The credit risk from exposures to financial counterparties has assumed a higher profile than usual. Nearly all corporates explained that their criteria for permitting dealing with a counterparty remained unchanged and usually started with credit ratings, layering on other criteria. What has changed, however, is a greater emphasis by most corporates on spreading the risk across more parties so that monetary limits on given names have been reduced. Limits such as "no more than 10% with any one party" have been introduced by some.

2.3.4 A few corporates take the opposite approach and concentrate their limits on banks deemed too big to fail, or prefer their credit exposures to be with relationship banks from whom they are borrowing at the same time. [*Observation:* This may provide some comfort but is unlikely to include a rigorous right of offset in case of a bank insolvency.] A number of corporates were also watching prices of credit derivatives that cover their bank counterparties. Where these had widened appreciably, actions to mitigate risk had been taken even if the rating of the bank had not altered. Monitoring concentration of risk by country was also being applied.

Use of AAAm Money market Funds

2.3.5 The desire for diversification and spreading of credit risk had caused some corporates to include in their cash investment portfolios investments in AAAm Money Market Funds, some generally preferring this over direct bank deposits or paper. However attitudes were very mixed. Some had stopped using Money Market Funds because of lack of transparency on the underlying investments. Others undertook initial and continuing due diligence on the funds' investments, were selective about the funds used, looked for a powerful fund sponsor and limited their investment to a small proportion of total fund size and an absolute amount.

Security over yield

2.3.6 Several corporates noted that stronger banks were overwhelmed with deposits and were still turning them away and offering very low rates on what they would accept. However, corporates are generally risk averse and prioritise security over yield.

Credit support agreements

2.3.7 Corporates have had plenty to do to manage their internal limits with banks as many banks' credit ratings have reduced and volatile markets have caused big swings in the mark-to-market value of derivative contracts. Some corporates have been asked to provide credit support to their banks by way of cash collateral or other security if pricing of the derivatives creates a credit exposure for the bank counter party, but without reciprocal rights. These demands are being resisted given the impact on liquidity and increased administrative burden. *Observation:* If credit support agreements require cross-collateralisation based on ratings triggers the negative spiral effect could be particularly dangerous.

2.3.8 Some corporates have reviewed their derivative instruments exposure to banks and have agreed or are considering requesting that credit support is provided by the banks in the form of collateral as derivatives go in an out of the money.

2.3.9 More generally corporates and banks are willing to provide credit support mutually if notional exposures go above some pre-agreed limits.

3 Feedback about Banks

Shrinking balance sheets

3.1.1 Banks are shrinking their balance sheets and improving their capital ratios. The UK authorities have said they are expecting capital ratios to fall somewhat in the coming periods and will not be concerned at that. Yet there is a perception that falling levels implies weakness for the bank.

Move to reduce client listings

3.1.2 One major bank has told clients that they are looking to reduce their number of target corporate customers in Europe from 5000 to 2000 over the next twelve months and other banks talk of reducing their corporate customers by a similar 60% (although mostly based on a smaller starting number). Banks are seemingly no longer pro-active to gain new business but are merely reactive – the reaction frequently being negative.

Linking borrowing to ancillary business

3.1.3 Relationships with the corporates' banks have become a priority, and ancillary business is a highly debated subject once again. Some banks are demanding a written acknowledgement from borrowers that in exchange for lending money they will be awarded a piece of ancillary business in the future. Traditionally treasurers might have promised relationship banks that they would at least be given the opportunity to quote for ancillary business[1].

Inconsistent messages

3.1.4 With increased volatility in credit markets, banks' credit committees and capital allocation committees (or other similar committees used by banks to select which credit approved deals they wish to allocate capital to) are becoming disconnected from relationship officers. As a consequence it is harder for borrowers to know whether their deal will be approved by a bank even though their relationship officer may be asserting it shall be. Members have asserted that banks give the impression that they do not know their own minds from day to day.

3.1.5 A regular request, from members, is for banks to provide more clarity and certainty about their appetite for new business. It is frustrating to be exploring and negotiating deals with the assurance that the bank is able to do it, only to find that a change in overall bank policy makes it unavailable, or only available under markedly changed conditions. "Banks are wrestling with what their own rules are" said one treasurer. Another said "Bankers don't know what they can deliver at the moment."

Banks' role in bond markets

3.1.6 In both the US and Euro public bond markets there are fewer banks willing to place borrowers' bonds, either because they are not prepared to provide a secondary market for those bonds or because they (the bank) are internally distracted. One upshot is that competition for new corporate issues is diminishing, even in Europe, and new issue fees appear to be being ratcheted up with little or no scope for negotiation.

3.1.7 Any increase now should not be supportable particularly as banks are unwilling to take risks when placing bonds and insist that pricing of the bonds is not agreed until after investors have been consulted, removing any underwriting risk. Some respondents were doubtful about what value banks were adding to either issuers or investors in these circumstances. A number of respondents reported "reverse enquiries" about bonds from investors, disintermediating the banks

Shift to tougher documentation and high cost of waivers

3.1.8 Banks are negotiating tighter documentation for loans but, worryingly for borrowers are using requests for minor or technical changes to documents to re-negotiate deals (pricing, maturity, terms, amount).

[1] Previous ACT work with members has shown that corporates prefer that bank products not be subject to cross-subsidies so that they can see clearly how they are generating banking costs and can adapt their activity to use less of expensive products (and possibly more of less expensive ones). If ancillary business is so profitable it subsidises lending, it is over priced and that distorts the market.

3.1.9 Two borrowers have highlighted the need to ensure that the accounting treatment of foreign exchange fluctuations (average vs year end) should not affect financial covenants. *Observation:* We believe that this issue is affecting many corporates.

3.1.10 Covenants that are computed using annual average exchange rates for balance sheet (debt) items, rather than a single year end measure, as well as for annual average exchange rates for cash flow (operating cash flow or EBITDA) and P&L items (interest) broadly eliminate foreign exchange movements from ratio calculations thus reducing the technical problem outlined above.

Administration within new facilities

3.1.11 In new lending agreements, a minimum drawdown period of 3 months is becoming the market norm, presumably prompted by worries by the lenders that liquidity in other periods might not be so good or to reduce administrative costs. For the borrowers this means they have to borrow larger amounts and place the cash on deposit to meet the normal fluctuations in needs from week to week. It also contrasts with the period of most intensive market disruption last autumn when banks were finding difficulty in funding periods of more than a few days.

Year end balance sheet management

3.1.12 Normally, leading up to the year-end, banks "manage" their balance sheets but the year end just passed seemingly saw more activity than usual, perhaps due to increased interest in those tier 1 ratios. Many corporates were called by their banks long before year end to ascertain how much of their facilities would be drawn at year end and relationship managers were exercised at any subsequent increases in expectations.

Benchmark for borrowing margins

3.1.13 For much of 2008, many banks were telling treasurers that the LIBOR settings used in loans were underestimating their true cost of funding. Several banks were reluctant to accept that the market did not regard them as the strongest of credits and had suggested that the panel banks must have been under estimating their real cost when submitting to the calculation panel. More recently, there has been more acceptance that a bank's cost of funds will be dependent on its perceived credit standing.

3.1.14 Some borrowers had been asked to consider using their variable credit default swap (CDS) spreads, or a proportion of it, for their borrowing margin over a LIBOR benchmark for their loans rather than locking in a (high) fixed borrowing margin for a number of years, in the expectation that CDS margins would fall. *Observation:* Of course, using an uncapped proportion of CDS spreads to price borrowing margins would help banks to hedge their credit risk to the borrower in the CDS market. Un-capped, such a pricing basis could lead to very high borrowing costs should CDS spreads worsen, making questionable the real availability of the line of credit[2].

[2] The ACT has issued guidance regarding the use of credit default swaps in loan pricing at http://www.treasurers.org/cdsloanpricing (registration needed)

3.1.15 LIBOR still seems to be the strongly favoured reference rate for both Banks and Corporates. We saw no evidence of any trend to price loans off base rate or other benchmarks. Overdrafts in general continue to price off base rate although a handful of borrowers had moved to pricing part (e.g. half) of their overdrafts off LIBOR at the request of banks to match more closely with the banks' cost of borrowing. For large corporates an overdraft rate of base + 1%, sometimes base 0.5%., was nearly always been the rule. It is now becoming common to find that the banks are increasing the rate to between base +1.5% and base +2%, to reflect the banks' true cost of funds which is linked to LIBOR.

US $ funding

3.1.16 Borrowing US dollars in some non-OECD, non US-dollar-based overseas territories has become more difficult with dollars a scarce resource. As a consequence banks in some of those territories were making loans priced off their own "cost of funds" rather than using the official LIBOR rates.

Market disruption clauses

3.1.17 For a few bilateral loans we heard that banks had tried to apply market disruption documentation to force the lending reference rate up but without success.

Clearing systems

3.1.18 In terms of normal clearing, pooling and banking systems members had not found any changes. One or two thought clearing prices might increase over time but also recognised clearing business does not attract significant capital and therefore already generates good revenue streams for banks. A particularly disruptive feature, flagged in a small number of cases, was concern by banks over daylight credit exposures. As a result ordinary cash management and regular payments and receipts had become far more complicated as the bank was not willing to make payments until receipts had cleared and covered outgoings.

State of mind

3.1.19 A number of members commented that to date a lack of recognition of reality had been witnessed in banks. Some banks were claiming they were 'open for business' for a product whereas in reality they had done little in the past few months and, given their situation, would likely need significant change to remedy their predicament.

Unrealistic returns expected – an over reaction?

3.1.20 Finally there is a worry, voiced by some, that banks say they are still targeting returns on equity of as much as 25%. Either this implies too much risk is likely to be accepted or too little business will be written. Either would be concerning.

4 Derivative Markets

4.1 Foreign exchange and commodity markets

4.1.1 In the Foreign Exchange markets members have not seen much impact on the liquidity and spreads to transact major currencies (e.g. $, € and £) in spot markets but spreads in other currencies, particularly emerging market currencies, have widened appreciably. In over the counter commodity markets some modest widening of bid/ask prices in the spot markets have also been noticed.

4.1.2 Forward foreign exchange and forward commodity market pricing has been extremely disparate amongst banks. Because banks have been finding it difficult to benchmark bids and offers for deposits and as banks have been adding different margins for counterparty credit[3] the pricing has been very variable. This has been true in major currencies as well as minor currencies.

4.1.3 For longer dated foreign exchange in major currencies, whilst corporates used to be able to deal immediately on the telephone, banks have taken longer to quote – deciding the appropriate counterparty credit margin and their own cost of funding. "Longer dated forwards and swaps are no longer commodity products" was the reaction from one treasurer.

4.1.4 The cross-currency basis swap provides a mechanism for moving from one currency to another. LIBOR funding in one currency can be converted into LIBOR funding in the other currency but within the transaction there remains a basis risk, meaning that the relationship between the two funding rates, in this case, is not perfect. For US$ in the last quarter of 2008 the pricing of the cross-currency basis swap was not only volatile from day to day but also generated significant additional costs, showing the shortage of US$, notwithstanding the activity of Central Banks providing US$ facilities to their member banks.

4.2 Interest and Inflation Rate Markets

4.2.1 In the **interest rate swap** markets disparate pricing amongst banks has also been an issue. Again, spreads for vanilla transactions have been much wider than normal and different banks have been quoting different rates for LIBOR and applied different credit margins to discount future cash flows[4]. This has been particularly true in the (less liquid) inflation rate swap markets.

4.2.2 Many members have break clauses in their documents governing their derivative contracts (ISDA agreements). These clauses provide that after perhaps 3,5 or 7 years either party may break the transaction. This allows both bank and corporate to ascribe lower potential counterparty risk knowing they could, if needed, break the transaction. In reality the expectation from both parties is that this will not occur and the bank usually indicated,

[3] Banks seem to be adding variously credit spreads for the client and for themselves and for their counterparties when they lay off the transaction with other banks – and they all make different judgements for each.

[4] This can cause issues with accounting as it may increase the basis risk between the hedging derivative and the hedged item.

informally, that it would not exercise its rights under the clause.

4.2.3 We have had feedback that some banks are terminating their exposures (despite informal undertakings to the contrary in better times) by exercising break clauses and, because the spread issues discussed above give difficulties in fairly pricing termination amounts, this is causing economic discomfort for some corporates. *Observation:* Some banks seem to be oblivious to the risk of longer term damage to their reputation.

5 Expectations for the future

5.1.1 Corporates were generally sanguine about their access to sufficient funding for the next year on account of pre-existing facilities but some were concerned about refinancing risk beyond this should conditions in the banking markets not improve.
For this reason some borrowers are planning to start their refinancing negotiations in good time and also to develop access to alternative non banking sources.
However, a few were prepared to wait until closer to when facilities mature before engaging with banks in detail. *Observation:* Although this may save money, it has a much higher degree of risk especially as our survey has shown banks generally willing to lend less. Not only prudence and general solvency concerns but, requirements related to determining a “going concern” basis for reporting may make it essential to have a clear view of financing for one year to 18 months ahead.

5.1.2 It was accepted by most that for many years to come the size of the banking market would be significantly reduced. However, it was expected that the capital markets would re-open for the larger corporates which used those markets in the past but were currently not able to access them, either because their rating was not sufficiently high or because they were in an unfavourable industry sector.

5.1.3 Some members went further believing that perhaps capital markets may develop to become more widely accessible by more corporates with disintermediation of banks a possibility. Private placement markets are likely to be important for smaller corporates with the caveat about documentation mentioned previously and the difficulties should amendments or waivers be required.

5.1.4 The need for a credit rating to access alternative investors was recognised and many currently unrated corporates were considering seeking their first rating.

5.1.5 Relationships are currently important in maintaining bank facilities and this is expected to continue. Some banks, seeking major changes in their dispositions, seem not to have had any attention to pre-existing relationships in their decision making – seeming not to have discriminated between clients’ credit standing and other risk factors nearly as much as might have been expected.

5.1.6 The much increased borrowing margins have become the new normal and while some abatement is expected, a return to the very attractive pre-crisis levels was seen as unlikely. In the conditions of recent years, better credits had not enjoyed the expected benefits of their prudence in borrowing margins as they were relatively low for all. However the perception was that the current borrowing margins were not truly representative of the probability of default/loss and consequently would reduce once banks were again competing to lend and there was less of a liquidity premium. However, it was agreed that this would take a considerable amount of time to work through.

6 Recommendations for corporates

6.1.1 It is very clear that the financial markets have changed significantly in the last 18-24 months and will remain uncertain and changeable in the near term. This survey has highlighted a number of areas that members of the ACT should consider and these are listed below. In any case a good place to start is with the advice in the ACT's briefing note Contingency Planning for a Downturn in the Economy: a treasurer's checklist at, http://www.treasurers.org/contingencyplanning, first published in April 2008.

- Rollover and re-negotiate bank loans as soon as possible ("Fund early and fund long"). It may seem to be cost effective to wait until nearer to maturity of facilities before engaging with banks before negotiating facilities. Our advice is to start early as banks' decisions are often very hard to predict at present. Much information can be gained by talking to other Treasurers/ACT Good advice can be obtained about which banks are in good order and may lend and others which may not.

- Review your capital structure and alignment with the group's (revised) strategy and market conditions

- For corporates who could in principle access the public capital markets (e.g. debt in excess of £300m-400m and market capitalisation of around £1bn or more) but do not have a rating, consider obtaining one to facilitate more diversity of funding and to avoid reliance on the bank markets.

- For smaller corporates: look at other non-bank markets e.g. private placements but only agree to terms that will not need changing during the life of the note . Some of the larger European investors have expressed an interest to the ACT in dis-intermediating banks by lending directly to corporates – the investors do not see the value intermediate banks are adding particularly as some are carrying less inventory.

- Consider setting up CP programmes.

- Shop around for prices for forwards, commodities & swaps.

- Think carefully about whether your counterparty policy is still appropriate given increasing volatility and lower ratings for banks although in some cases they are supported by governments.

- Consider the pros and cons of credit support agreements with your counterparties. Consider the requirement for corporates to give credit support for their own obligations in relation to derivatives which may increase banks' counterparty limits previously consumed by outstanding derivative positions.

- Consider set-off arrangements very carefully across the board for your dealings with a bank to reduce your exposure to its credit.
- Check existing bank documents very carefully to ensure compliance as waivers could be difficult or expensive to obtain, potentially resulting in loss of facilities or continuation of facilities with reduced amounts, increased costs and additional onerous obligations.
- Ascertain how much is spent with banks across the corporation and help your relationship officer understand the full revenue flow received. Bank income might be from M&A advice, broking advice, share buybacks, employee share/option schemes, pension schemes, custody arrangements, ADR programme management, deposits, foreign exchange, interest and inflation rate swaps, CP dealerships, bond issues, commodity business, provision of bonds, guarantees, letters of credit, clearing and system charges, credit card charges, vehicle and other leasing programmes. Remember that banks price according to economic cycles and not always with full knowledge of their overhead costs and true cost of capital, the full range of banking business undertaken by the corporate or the overall value of the particular relationship.
- Check with the corporate's auditors, early in the cycle, what additional comfort they need for their 'going concern' reviews.
- Investigate the corporate's pension fund and the impact caused by dislocations in interest rate markets and inflation markets as well as widening borrowing margins and falling equity prices. Also review the pension fund's counterparty exposures and how they are being managed together with the overall group exposures..
- Ensure the Treasurer is aware of all positions in commodities and their mark to market values
- Consider whether uncommitted lines for performance bonds and similar facilities are sufficient for your corporate's needs
- Ensure that banks are not allocating credit for facilities etc. that are no longer needed or that central treasury is unaware of.
- Lastly and most importantly communicate financing plans as appropriate to the corporate's Board, its credit rating agencies, its banks, and to its capital market investors.

7 Appendices

Appendix 1

Size breakdown of corporates surveyed

		Number of corporates interviewed
FTSE 100	Top 50	10
	51-100	9
FTSE250	101- 225	11
	225-350	6
Other non listed		7
TOTAL		43

Appendix 2

Data Tables

£ Overdraft current pricing

Unchanged at Base +1%	Base + 1.5%	Between B +1.5% and B+2.0%	Base +2%
50%	10%	30%	10%

Credit margins: Estimated current margins as percentage of pre-crisis margins

Multiple of pre crisis margins	<250%	250%-350%	351% - 451%	451% - 550%	>550%	Multiple of pre crisis margins
	20%	5%	31%	19%	25%	

Continuing availability of uncommitted lines:

No change in availability of lines	Marginal reduction in uncommitted lines	Significant cutback in available lines
50%	31%	19%

Earliest refinancing needs:

Facilities falling due not already covered by cash	2009	2010	2011	2012 and beyond
	0%	30%	35%	35%

Changes in customer payment timings

Are customers paying later?	Yes - major change	Yes - modest change	No
	0	22%	78%

Appendix 3

References

Graph 1: Borrowing margins – RBS, Dealogic

Graph 2: Corporate bond issuance – RBS, Dealogic

Graphs 3: Prime 1 commercial paper outstandings & Graph 4: Prime 2 commercial paper outstandings – RBS, USCP – Federal Reserve Website, European CP – Euroclear website and Capital Markets Daily ltd.

Graph 5: Corporate syndicated loan volumes – RBS, Thomson/Reuters

The ACT welcomes comments on this report

Please send your comments to technical@treasurers.org

Report

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